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northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Fall 1979 Regional Economic Survey

November 13, 1979

Highlights

- **Despite a rebound in economic activity during the third quarter of this year, increasing numbers of Twin Cities bankers are braced for a recession. Over 40 percent of the bankers in the metropolitan area are expecting economic conditions to deteriorate during the next six months, sending the confidence index for the Twin Cities to its lowest level since this survey began. Pessimism also prevails among Minnesota Iron Range bankers, a sharp reversal of attitudes since last April.**
- **In contrast, agricultural bankers in the Upper Midwest expect their communities will be spared the impact of a national economic down turn. Some farmers are benefiting from the best of all worlds: record crops and higher prices. Over half of the agricultural bankers expect a continuation of current favorable conditions; another 23 percent anticipate improvement in economic conditions. The economic outlook, however, is much more subdued in the western portions of Montana and South Dakota where very poor moisture conditions prevail.**
- **Interest rates continued their steep climb at Twin Cities and Iron Range banks reflecting heavy loan demand, tighter monetary policy and sharp increases in costs of deposits and purchased funds. While still lagging behind rates in nonfarm areas, interest rates charged by agricultural banks have also risen sharply. The recent credit tightening by the Federal Reserve is causing agricultural bankers to ration credit based on the purpose of the loans as interest rates in some states are bumping up against usery limits, especially those for smaller-sized borrowers.**
- **Loan-to-deposit ratios at agricultural banks are at an all-time high as deposits have not kept pace with the surge in loan demand. About one-third of the agricultural bankers said they turned down loan requests due to lack of funds and nearly half were less active in seeking new customers. The largest jump in loan-to-deposit ratios occurred in Minnesota and the Dakotas where significant numbers of bankers indicated that transportation problems and the grain handlers strike in Duluth had a severe affect on the availability of loan funds.**
- **Agricultural bankers anticipate continued strong growth in farm loan volume over the next year. Loans for crop operating expenses are expected to increase the most due to escalating production costs and increased crop acreage in 1980. Heavy loan demand will keep pressure on agricultural bank liquidity, although increased marketing of grain should help ease liquidity pressures. However, agricultural bankers feel that grain transportation bottlenecks will continue to plague agriculture in this region.**
- **Record interest rates and a faltering economy are expected to dampen the growth of loan demand in the Twin Cities during the next six months. Home mortgages are expected to show the greatest weakness. Even greater softening of loan demand is expected in the Iron Range area.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Economic Outlook

Our seventh semi-annual survey of Upper Midwest bankers reveals considerable differences in the economic outlook for the farm and non-farm segments of this region's economy. Fading optimism in the Twin Cities area over the past year and a half has now turned to pessimism. The confidence index for the Twin Cities fell to its lowest level since the survey began three years ago. Over 40 percent of Twin Cities bankers expect economic conditions to deteriorate during the next six months, while only 12 percent expect conditions to improve.

Although Twin Cities bankers appear to be braced for a recession, they expect the local economy to be less severely affected than the national economy.

Pessimism also prevails in the Minnesota Iron Range area. About 46 percent of the Iron Range bankers expect economic conditions to become worse over the next six months; only 15 percent feel conditions will improve. This is a sharp change in attitudes since our survey this past April when nearly 40 percent of the Iron Range bankers expected economic conditions would improve.

The survey also reveals that agricultural bankers in the Upper Midwest are not fearful of a recession. Over 50 percent of the agricultural bankers expect the current favorable economic conditions to continue. Another 23 percent expect economic conditions will improve. The outlook, however, is more subdued in the western parts of Montana and South

Dakota where half of the bankers expect economic conditions to deteriorate during the next six months. This attitude in part reflects the very poor moisture conditions prevailing in that portion of the country.

This picture emerges from survey responses from about 650 bankers located in the Twin Cities, Minnesota's Iron Range and agricultural communities in Iowa, Minnesota, Montana, Nebraska, North and South Dakota and western Wisconsin. The survey was conducted in early October.

In the following discussion, banks in the Twin Cities and Iron Range areas are referred to as "metro banks" and banks in the other areas of the seven-state Upper Midwest region are referred to as "agricultural banks".

Business Conditions

Retail Sales: The survey provides evidence that the growth of retail sales is slowing in the metro region. While 30 percent of the Twin Cities bankers indicated that retail sales are better than a year ago, over half felt retail sales are about the same as last year. This is the smallest amount of improvement reported since the survey began. Retail sales appear to be even more sluggish in the Iron Range area.

Despite sales promotions and cash rebates, over 60 percent of the metro bankers reported a drop in auto sales during the past 12 months. Metro bankers indicate that major household appliance sales also show definite signs of softness. Even so, the worst is yet to come. On the bright side, the majority of metro bankers report little change in retail inventories during the past year, suggesting that retailers have been successful in preventing undue accumulation of inventories.

The majority of agricultural bankers indicate that retail sales are about the same as one year ago, however, their responses vary considerably by area. Retail sales are the least robust in western South Dakota and the Red River Valley areas of Minnesota and North Dakota where 40 percent of the bankers felt retail sales are worse than last year. This decline reflects the impact of the grain strike in Duluth, various weather related problems and the more modest improvement in farm income reported for those sections of the region. The survey also reveals that auto and truck sales are generally weak throughout the agricultural communities in the seven-state region.

Housing: Rapidly rising prices and high interest rates have taken a definite toll on the housing market. Over half of the Iron Range banks and nearly 70 of Twin Cities banks report lower housing starts compared to a year ago. In addition, practically all Twin Cities bankers reported that existing homes are selling at a slower pace than a year ago. Existing homes sales are also weak in the Iron Range area.

The Federal Reserve's new monetary policy is expected to have a serious impact on the housing industry. Besides higher mortgage rates, reduced availability of funds will cut increased numbers of home buyers out of the market. A number of lenders in the Twin Cities area already have, at least temporarily, withdrawn from the mortgage market due to lack of funds.

The recent change in Minnesota's usury law will prevent mortgage money from drying up completely. Nevertheless, savings outflows from financial institutions have reduced the availability of mortgage money. In addition, due to the jump in interest rates sought by investors, lenders are less able to sell mortgages from their portfolios in the secondary market and thereby free up additional mortgage funds.

Capital Expenditures: The pattern of capital spending varies considerably throughout our region. In the Twin Cities, capital expenditures on plant and equipment are reported to be holding up better than consumer expenditures. In contrast, over 60 percent of the Iron Range bankers report declines in capital expenditures, reflecting the end of a major construction boom in the taconite industry.

Agricultural bankers indicate that although capital outlays remain fairly strong, expenditures on machinery and equipment are not as robust as six months ago. The strongest growth was reported in Wisconsin. On the other hand, substantial deacceleration in spending was noticed in the Minnesota Red River Valley, North Dakota and eastern Montana.

Part of this weakness is related to the difficulties farmers encountered in selling grain this past summer. Some bankers report that farmers are continuing to postpone machinery and equipment purchases in response to tighter credit conditions, rising interest costs and unresolved transportation problems.

Farm Income: Over half of the agricultural bankers indicate that farm income is higher than last year's favorable level. In a number of areas farmers are benefiting from the best of all worlds: record crops and, thanks to strong export demand, higher prices. Income of dairy farmers in Wisconsin and cow-calf operators in Montana have also improved significantly due to favorable prices. Inflation, however, makes the rise less spectacular in real terms.

The smallest income gains were reported for the Red River Valley and western South Dakota.

Credit Conditions

Cost of Credit: Interest rates have continued their steep climb. During the past year, the average lending rate charged for working capital loans rose by 2.6 percentage points at Twin Cities banks, reaching 13.26 percent in early October. During the same period interest rates for working capital loans rose by 2.44 percentage points to 13.15 percent at Iron Range banks. The new stringent monetary policy actions by the Federal Reserve (Fed) has pushed interest rates even higher.

In the past, interest rates charged by most agricultural banks have not been set up to follow money market rates. Recently, this tendency appears to be breaking down as the cost of funds has shot up dramatically. While still lagging behind rates in nonfarm areas, interest rates charged by agricultural banks have risen sharply.

During the past year, the average lending rate charged by agricultural banks for farm operating loans jumped by over two percentage points reaching 11.38 percent in early October. And rates have continued to rise due to the recent credit tightening by the Fed. This is causing bankers to ration credit

based on the purpose of the loans as interest rates are bumping up against usury ceilings, especially those for smaller-sized borrowers, in states such as Iowa and South Dakota.

Lending rates have risen in response to strong loan demand, liquidity pressures, increased costs of purchased funds as the Federal Reserve tightened credit conditions and higher rates paid on deposits including a shift towards money market certificates. More than half of the agricultural bankers said that six month money market certificates comprise over 10 percent of their consumer time deposits. Just one year ago these money market certificates accounted for less than 5 percent of the time deposits at nearly all agricultural banks. This shift towards more costly deposits has also occurred at metro banks.

Availability of Credit: After showing a sharp increase this past spring, the average loan-to-deposit ratio at Twin Cities banks has stabilized at 68.7 percent. Nevertheless, the survey results suggest that credit conditions are tight. Over 90 percent of Twin Cities banks said their loan demand was higher than a year ago. Moreover, during the past six months, over two-fifths of the bankers stated that they denied loan applications due to lack of funds. A significant number of these loan applications are likely to have been for home mortgages. The same number of bankers said they were less active than normal in seeking new loan accounts. They also relied more heavily on purchasing Fed funds to meet their rising loan demand.

Iron Range banks also experienced tighter liquidity. Over 90 percent of the banks reported higher loan volume compared to a year earlier, while only 40 percent indicated that their demand deposits were higher. As a result the average loan-to-deposit ratio increased to 71.4 percent, up 0.54 percentage points in the past six months and 2.35 points in the past year. About 45 percent of the banks reported ratios of 75 percent or larger.

As was the case for Twin Cities banks, 40 percent of the Iron Range banks indicated they denied a larger than normal number of loan requests due to lack of funds and that they were less active in seeking new customers. The

REGIONAL ECONOMIC SURVEY SUMMARY TABLE
FALL 1979

BUSINESS CONDITIONS*

(1) Is **farm income** higher or lower than it was a year ago?

	Higher	About the Same	Lower
Ag Banks	54%	36%	10%

(2) Are **retail sales** better or worse than they were a year ago?

	Better	About the Same	Worse
Ag Banks	21%	61%	18%
Twin City Banks	32%	53%	15%
Iron Range Banks	31%	46%	23%

(3) Are farmers (local businessmen) making more or less **capital expenditures** (such as buildings, machinery, and other farm and business equipment) than a year ago?

	More	About the Same	Less
Ag Banks	27%	51%	22%
Twin City Banks	20%	56%	24%
Iron Range Banks	8%	31%	61%

(4) Are **land prices** higher or lower than a year ago?

	Higher	About the Same	Lower
Ag Banks	75%	25%	0%

(5) Do you think the **overall economic condition** in your area will be better or worse six months from now?

	Better	About the Same	Worse
Ag Banks	23%	54%	23%
Twin City Banks	12%	45%	43%
Iron Range Banks	15%	39%	46%

CREDIT CONDITIONS

(6) Are your customers **repaying loans** at a faster or slower rate than they did a year ago?

	Faster	About the Same	Slower
Ag Banks	5%	56%	38%
Twin City Banks	2%	74%	24%
Iron Range Banks	0%	62%	38%

(7) In the past six months did your bank **deny loan requests** due to lack of funds?

	More Than Normal	No More Than Normal	Less Than Normal
Ag Banks	33%	61%	6%
Twin City Banks	41%	44%	15%
Iron Range Banks	38%	38%	23%

(8) What impact did **transportation problems** and the **grain handlers strike** have on loan funds availability?

	Little	Moderate	Severe
Ag Banks:			
Minn. Red River Valley	0%	50%	50%
South Dakota	26%	40%	34%
North Dakota	7%	38%	55%

(9) Do you think your **loan demand** will be higher or lower six months from now?

	Higher	About the Same	Lower
Ag Banks	77%	21%	1%
Twin City Banks	39%	39%	22%
Iron Range Banks	31%	38%	31%

AGRICULTURAL CONDITIONS

(10) What are the present **subsoil moisture conditions** in your area?

	Above Normal	Normal	Below Normal
Ag Banks	31%	38%	31%

(11) What changes do you expect in **beef cattle breeding herds** in your area in 1980?

	Increase	No Change	Decrease
Ag Banks	40%	57%	3%

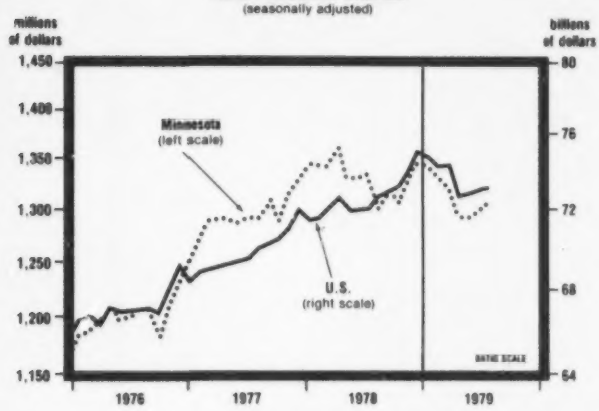
(12) Excluding grain still under CCC loan, are farmers **holding more or less grain** than they did a year ago?

	More	Same	Less
Ag Banks	58%	36%	6%

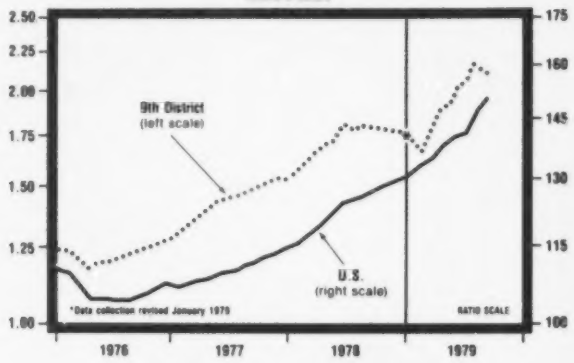
*Data show proporation of bankers falling in each of the categories higher, same, lower, etc.

REGIONAL ECONOMIC CONDITIONS

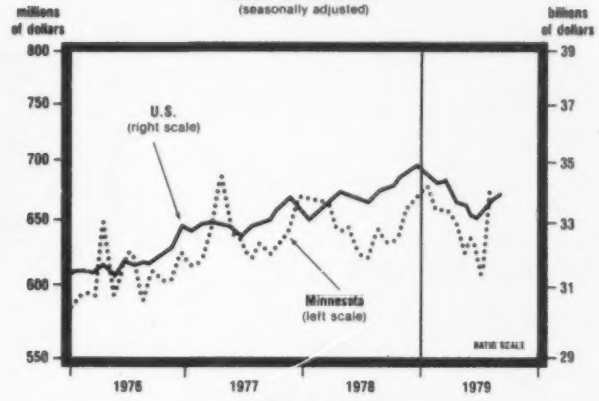
REAL PERSONAL INCOME
(seasonally adjusted)



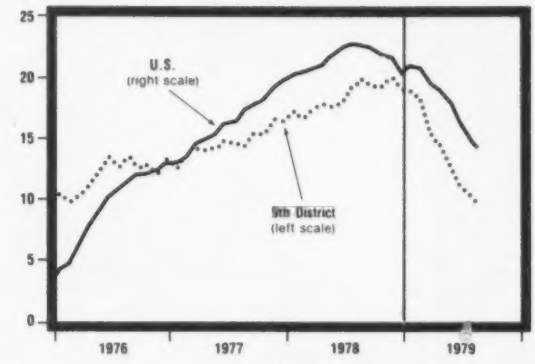
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS
(seasonally adjusted)
billions of dollars



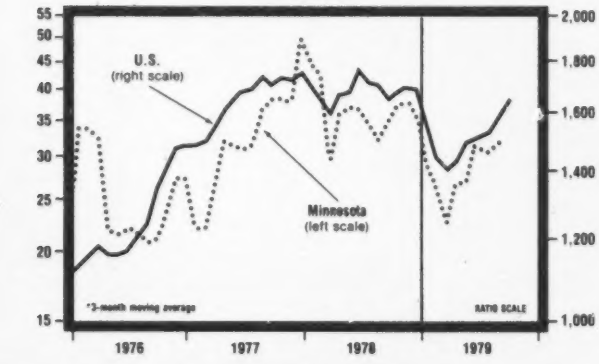
REAL RETAIL SALES
(seasonally adjusted)



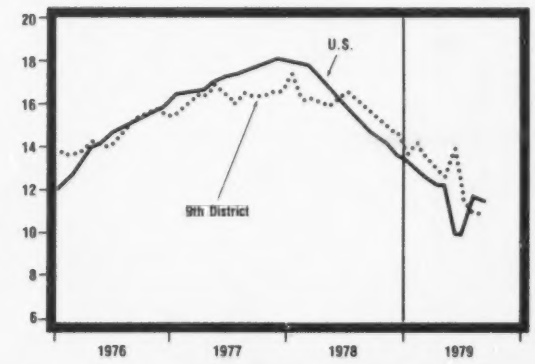
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



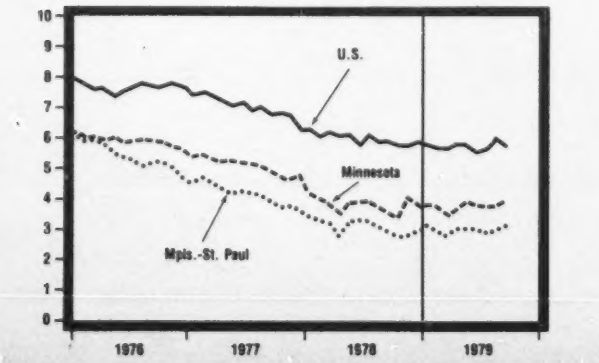
HOUSING PERMITS
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



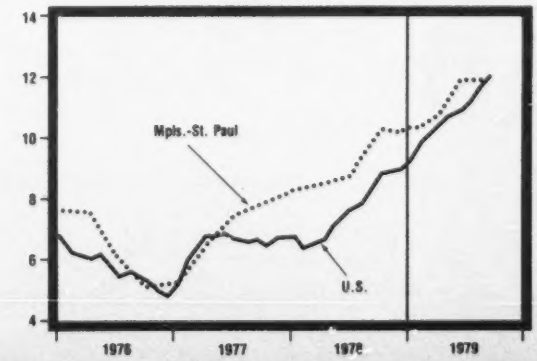
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force

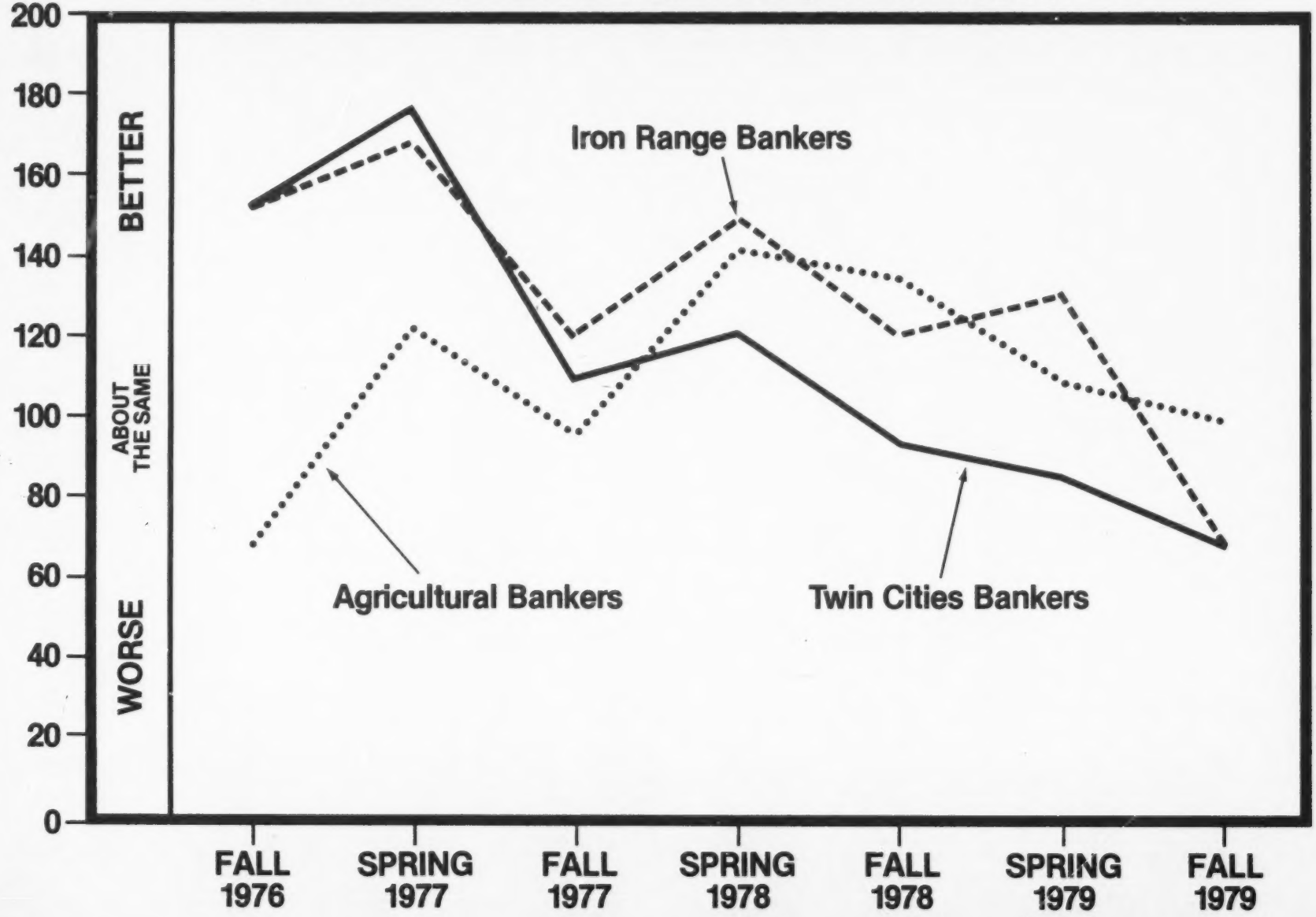


CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



UPPER MIDWEST CONFIDENCE INDEX

Percent of bankers expecting economic conditions to improve
minus percent expecting conditions to deteriorate during the next six months plus 100.



survey results also reveal a definite slowdown in loan repayment rates.

In the farm communities, loan demand continued to out-distance the growth of demand deposits. Accordingly, the loan-to-deposit ratios at agricultural banks are at an all-time high and are likely to go higher. Even so, the quality of agricultural loans appears to be good. The loan-to-deposit ratio averaged 68.9 percent at agricultural banks, up 4 percentage points in the past 12 months. One-third of the agricultural banks had ratios of 75 percent or more. Just three years ago, the loan-to-deposit ratio averaged 57.5 percent for agricultural banks.

Among the seven states surveyed, the average loan-to-deposit ratio ranged from 66.7 percent in Iowa to 73.3 percent in Wisconsin. The greatest increase in this ratio occurred in the Dakotas (up more than 6 percentage points) and in Minnesota (up 4 percentage points); grain transportation problems and the grain handlers strike in Duluth affected these areas the most. A significant number of bankers in the Dakotas and the Minnesota Red River Valley indicated that transportation problems and the grain handlers strike had a severe affect on the availability of loan funds.

Further evidence of tight credit conditions is obtained from reports that about one-third of the agricultural banks turned down loan requests due to lack of funds. In addition, nearly 50 percent were less active in seeking new customers and over 40 percent relied more heavily on purchasing Fed funds.

Future Loan Demand: As a result of the current high interest rates and the anticipated downturn in the local economy, Twin Cities bankers expect loan volume to grow at a more moderate pace during the next six months. Home mortgages are expected to show the greatest weakness. While moderating somewhat, commercial and industrial loan demand is expected to remain relatively strong.

Bankers feel that loan demand will weaken even more in the Iron Range area during the next six months. Over 50 percent of the Iron Range bankers expect mortgage loan demand to decline and nearly that number anticipate a decline in commercial and industrial loan volume.

In contrast, the strong agricultural loan demand is projected to continue, with 77 percent of the bankers expecting higher loan volume a year from now. Although bankers feel that all areas of loan demand will remain strong, loans for crop operating expenses are expected to increase the most. This reflects escalating crop production costs, especially for fuel and fertilizer, as well as increased crop acreage next year due to the elimination of set-aside requirements for wheat and feed grains.

Other areas of continued strong loan demand include livestock, machinery and equipment, and crop inventories. The projected heavy loan demand will keep pressure on agricultural bank liquidity, although increased marketing of grain should help ease liquidity pressures.

Agricultural Conditions

Moisture Conditions: Subsoil moisture conditions are highly variable throughout the seven state region. Nearly 100 percent of the bankers in Montana reported below normal subsoil moisture. This caused germination problems for winter wheat and rye. Below normal moisture conditions were also reported in western South Dakota and parts of North Dakota. On the other hand, above normal subsoil moisture conditions exist in south-central Minnesota and Iowa.

Grain Storage: Despite higher grain prices this past summer, nearly 60 percent of the agricultural bankers report that farmers are holding more grain than a year ago. Increased holdings of grain are especially evident in eastern South Dakota, North Dakota and the Minnesota Red River Valley. This reflects the impact of the 11-week strike at the Port of Duluth, the independent truckers strike and other transportation bottlenecks. Bankers in these same areas indicate that the grain handlers strike and transportation problems had a serious negative impact on grain prices and storage capacity. Other parts of the 7-state region were less severely impacted.

1980 Crop Acreage: Bankers do not anticipate any major shifts in crop production next year. Wheat, corn and soybean acreage are all expected to rise as idled-acres are brought back into production. The outlook for soybeans could be altered depending on price trends before the planting season. Slight reductions are anticipated in small grain acreage, while sunflower acreage is expected to continue to expand in 1980.

Livestock: Bankers expect beef prices to increase during the next six months as a result of the smaller number of cattle reported on feed. In 1980, ranchers are expected to respond to favorable feeder cattle prices by increasing their beef breeding herds. However, it will be quite some time before increased supplies show up on the dinner table.

Due to sharp increases in hog production, bankers expect pork prices to remain at the unprofitable levels which existed during early October. Despite these low prices, agricultural bankers expect little change in hog breeding herds during the next six months.

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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Agricultural Outlook

December 20, 1979

Highlights

- **In 1980, U.S. agricultural exports are expected to increase 20 percent, topping the record established just this year, as feed grain, wheat and soybean sales lead the way. Reaching this export potential will require extremely efficient utilization of transportation and port facilities along with orderly marketing of grain by farmers. Any major disruption would impede export growth with the consequence of lower prices for American farmers.**
- **Elimination of acreage set-aside requirements plus stronger grain prices should boost crop acreage to record levels next year. Wheat acreage is expected to show the largest increase and could lead to lower wheat prices once the 1980 crop becomes more certain. Soybean acreage probably will be reduced in 1980 as a more normal Brazilian crop combined with record U.S. supplies push soybean prices substantially below this year's level.**
- **Transportation limitations have caused corn prices to be considerably lower in the western portion of the corn belt compared to other parts of the country. This will encourage livestock feeding in that portion of the country.**
- **Despite a dramatic decline in beef supplies during the first part of 1980, a weak general economy plus large supplies of pork and poultry will keep cattle prices lower than otherwise would be possible. Nevertheless, cattle prices are expected to strengthen by the middle of next year. As a result there is a danger that cattle feedlot operators will again bid too aggressively for feeder cattle.**
- **Despite the boom in exports, net farm income is expected to drop by around 10 percent next year. Escalating production expenses will more than offset modest increases in prices received by farmers. Fuel and fertilizer are likely to pace next year's rise in farm production costs.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Volatility characterized the agricultural scene in 1979. Livestock prices rose to new highs early in the year, then fell to unprofitable levels in the second half of the year.

Corn and soybean production set new records in the United States, while Soviet grain production plunged nearly 25 percent from a year earlier. Grain and soybean prices rose dramatically in response to adverse weather reports in both the United States and abroad. Then prices receded as it became apparent that U. S. crops would accommodate the Soviet shortfall.

Grain marketing was disrupted by strikes and transportation difficulties. Weather problems plagued crop production from start to finish. And, wet fields have prevented the harvest from being completed.

What's in store for 1980? How will overall economic conditions affect farmers?

Agricultural Trade

The brightest spot in the U.S. agricultural outlook clearly is exports, reflecting record domestic crops and the poor grain harvest in the Soviet Union. The USDA expects agricultural exports to reach a new peak of $38 billion in fiscal year 1980 (which began October 1, 1979), up 20 percent from the record set in fiscal 1979.

Although imports are also expected to climb to new highs, the agricultural trade surplus in fiscal 1980 is expected to set another record. Thus, once again, a hefty agricultural trade surplus will go a long way toward easing U.S. balance of payments problems and helping to pay for expensive petroleum imports.

The export outlook, however, is by no means certain. Transportation constraints and bottlenecks appear to be the greatest hurdle the United States faces in

achieving this enormous export expansion. Meeting this challenge requires extremely efficient utilization of transportation and port facilities along with orderly marketing of grain by farmers. Any major disruption in the grain transportation system would impede export growth, with the consequence of lower prices for American farmers.

Several other factors could slow export growth in 1980. These include weaker foreign demand as the recession spreads to other countries, balance of payment pressures in major importing countries due to escalating oil prices and a stronger U.S. dollar which would make U.S. farm products more expensive abroad. Thus, although agricultural exports will indeed expand sharply in 1980, a variety of factors could prevent exports from reaching levels projected by the USDA.

Crop Outlook

Corn: The feed grain outlook is dominated by conditions in the United States and the Soviet Union. The U.S. corn crop this year is now estimated at nearly 7.6 billion bushels, up seven percent from last year's record crop. On the other hand, the Soviets had the poorest grain harvest in four years and are turning to the United States to sustain their meat production objectives.

Sharply higher U.S. exports and moderately increased domestic use during the 1979/80 marketing year will push total utilization to record levels. Even so, U.S. carry-over stocks of corn next October probably will exceed this year's high level. Nevertheless, corn prices in 1979/80 are expected to average somewhat above last year due to the anticipated reduction in total world stocks of feed grains.

Of course, farmers have not shared equally in this year's record corn harvest. Minnesota was one of the few states which experienced a decline in yields and considerable amounts of corn still remain in the fields. Profits were further eroded as the high moisture content of the corn necessitated expensive drying.

Transportation limitations have caused corn prices to be considerably lower in the western portion of the corn belt than in other parts of the country.

Oilseed Outlook: The 1980 outlook for oilseeds is highlighted by record U.S. production. This year's soybean crop, estimated at 2.2 billion bushels, was 20 percent above last year's record crop. Both domestic and overseas demand are expected to continue to expand, but not nearly as sharply as supply. Hence, carry-over stocks of soybeans are expected to more than double next fall.

The soybean price outlook is rather pessimistic for the next year. During the past two years the United States has experienced a major upsurge in soybean export demand due primarily to two poor soybean harvests in Brazil. If Brazil experiences normal yields next spring, American farmers will experience increased competition in world markets. This combined with record U.S. supplies is expected to push soybean prices substantially below this year's level.

American farmers have nearly doubled sunflower production this year due to record plantings and yields. The development of high-oil-content hybrid seed has boosted the United States to second place in world sunflower seed production, next to the Soviet Union. Moreover, the United States is the world's largest exporter of sunflower seeds. Due to the record oilseed crop, sunflower seed prices are also expected to average below last season's level.

Wheat: A 10 percent increase in harvested acreage and a record yield resulted in a U.S. wheat crop of 2.1 billion bushels, up 18 percent from 1978, and the third largest crop ever. This big crop reflects record harvests of winter wheat in Kansas, Oklahoma and Texas. On the other hand, production of durum and other spring wheat was down six percent from last year due to decreased yields.

The wheat export picture looks bright for the current marketing year. Production in the Soviet Union declined about 30 percent. With strong export demand, utilization will likely exceed U.S. production for the second straight year, thereby reducing carry-over stocks next year. Wheat prices should remain strong until the 1980 crop becomes more certain. Increased wheat acreage in 1980, however, could weaken wheat prices considerably in the second half of 1980.

Crop Acreage: Next year will mark the first time since 1977 that an acreage set-aside program will not be in effect for wheat and feedgrains. The elimination of the set-aside requirements plus stronger grain prices should boost crop acreage to record levels next year.

Wheat acreage is expected to show the largest increase, approaching 10 percent. However, wheat production probably will not increase by the same proportions, as yields are likely to fall to more normal levels.

With corn prices strong relative to those for oilseeds, U.S. farmers are expected to devote more acreage to corn in 1980. Nevertheless, as yields drop back to more normal levels, corn production is likely to decline somewhat from the record level reached this year to around the seven billion bushel range in 1980.

In contrast to wheat and corn, soybean plantings probably will be cut back in 1980, interrupting the 42 percent expansion in soybean acreage over the past three years. This reduction in soybean acreage will be necessary to offset the expected upsurge in carry-over stocks in 1980. In parts of the Upper Midwest, however, the decline in soybean acreage may be slowed as wet fields and unfinished field work this fall delay the planting season next spring.

Sunflower seed acreage is also likely to increase much less dramatically in 1980, and could even drop from the record 1979 level.

Livestock

Hogs: U.S. pork producers have experienced a dramatic turnaround in their profits during the second half of 1979. In February, hog prices rose to their highest level since 1975. Since that time, however, record pork supplies have pushed hog prices below the cost of production.

Even though profits have been squeezed in recent months, hog producers are still planning substantial increases in production during the first half of 1980, delaying the expected cut back in pork supplies until later in the year. The modest improvement in hog prices this past November could slow the pending production cuts, thereby causing additional price weakness in 1980. Nevertheless, pork prices should strengthen throughout the year with profits returning to the industry as supplies recede during the second half of the year.

Beef: For cattle feeders, 1979 has been a year of contrasts and extremes. In 1979, commercial beef production will be down 12 percent from a year earlier. A sharp decline in feedlot placements and marketings along with record grain and soybean harvests normally signal stronger cattle prices and lower feed costs. However, competition from large supplies of poultry and pork plus a weaker economy have held beef prices down during the second half of this year while feed prices rose due to strong export demand.

During the first half of 1980, beef supplies will continue their dramatic decline, suggesting that a significant jump in beef prices is in the offing. Large supplies of pork and poultry, however, are expected to keep total meat and poultry supplies above year earlier levels at least through the first quarter of 1980.

In addition, a weak economy will certainly constrain the demand for beef. Within agriculture, the beef sector is probably the one most directly affected by a recession. And declining real consumer income is expected to have its greatest impact on the demand for beef during the first quarter of 1980. Thus, large supplies of competing meats and a weak general economy will likely keep cattle prices lower than otherwise would be possible.

Nevertheless, cattle prices are expected to strengthen by the middle of next year. Beef packing plants will experience a dramatic decline in volume during the second quarter of 1980. Supplies of competing meats will also begin to taper off. Accordingly, cattle prices could reach the $75 range by mid-year.

Since cattle feeders have been experiencing losses this fall, feeder cattle prices must be considered too high. Ranchers, of course, would say that the demand for finished cattle is too low. Cattle on feed reports, which have consistently been optimistic in the long-run, caused feedlot operators to bid aggressively for feeder cattle this past April. While feeder cattle prices have retreated from the highs of last spring, there is a danger that feedlot operators will again bid too aggressively for feeder cattle next year as finished cattle prices increase.

Farm Income

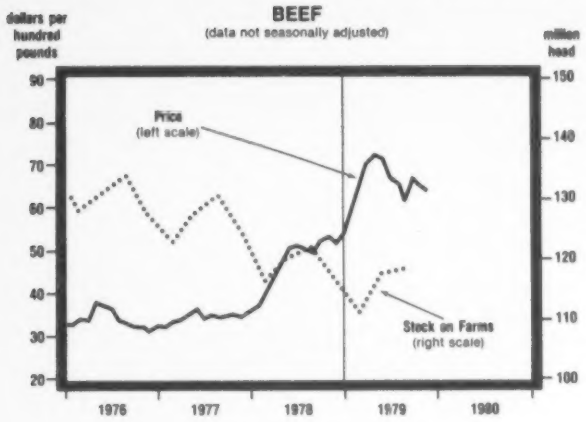
Net farm income in 1979 is expected to total just over $31 billion, the second highest in history and a gain of about 12 percent from 1978. This relatively favorable net farm income picture stems from sharply higher livestock prices in the first half of this year and a record grain harvest, with prices supported by strong export demand. Once adjustments are made for inflation, however, net farm income showed little change from the favorable level attained in 1978.

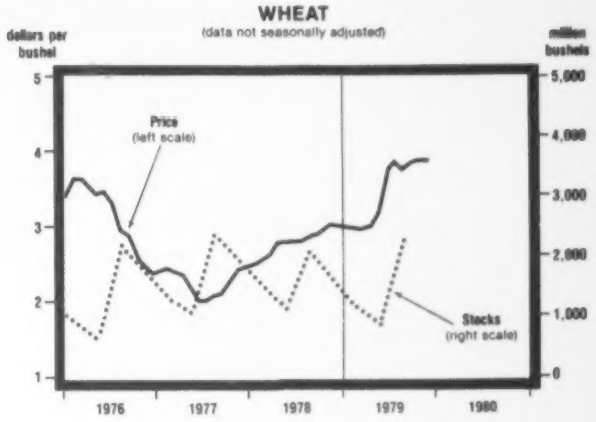
Rising food prices have made the news this past year, but farmers are also affected by inflation. Next year escalating production expenses are expected to more than offset income gains, thereby reducing net farm income. The costs of fuel and fertilizer are expected to increase the most. As a result, the USDA estimates that net farm income will decline by 20 percent in 1980.

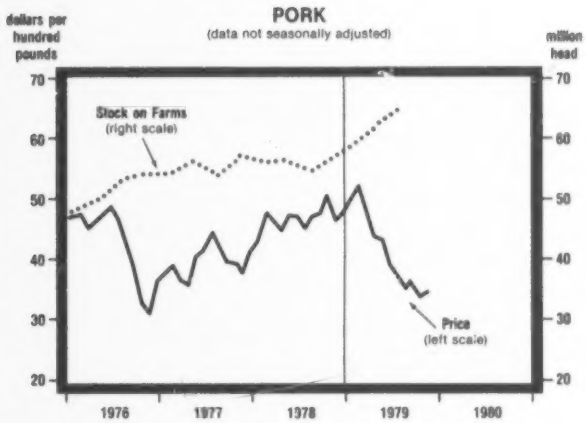
This estimate, however, is very sensitive to small changes in farm prices. A one percent increase in the prices received by farmers translates directly into a $1.3 billion increase in net farm income. USDA estimates of livestock prices in particular seem too pessimistic. Thus farm income is more likely to decline by around 10 percent next year. Moreover, the decline in net farm income will not be shared equally by all farmers. The outlook is more favorable for feed grain, feeder cattle and dairy producers.

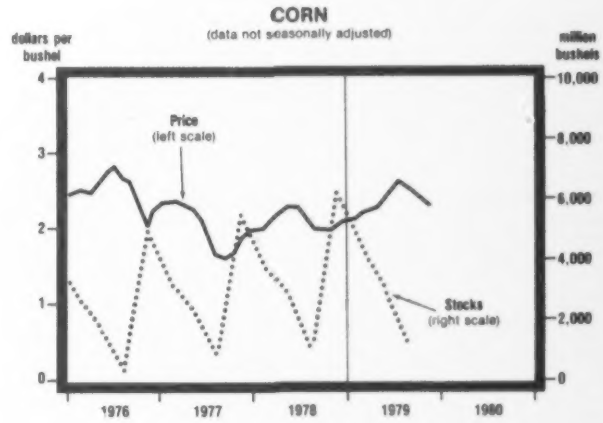
Dr. Larry J. Wipf
Assistant Vice President
Director of Regional Economics

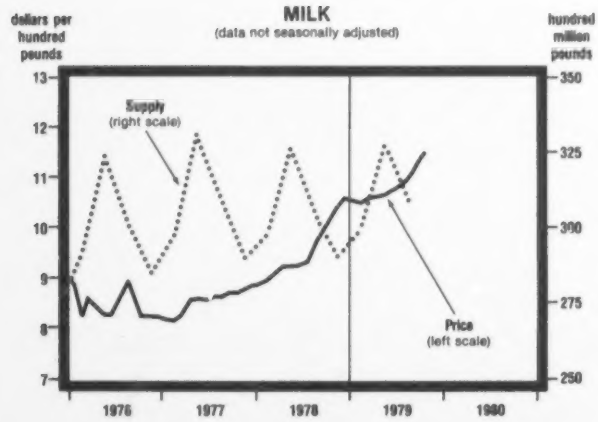
AGRICULTURAL CONDITIONS

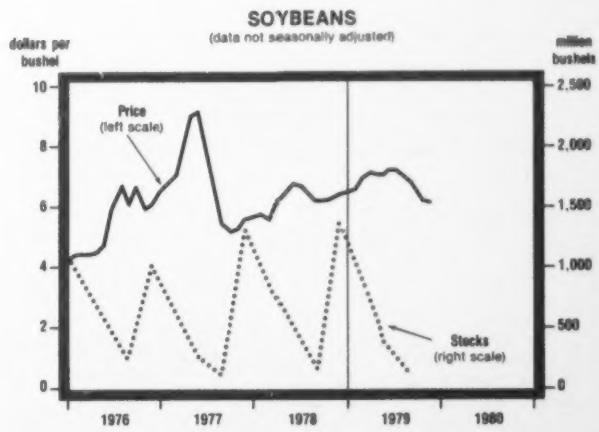






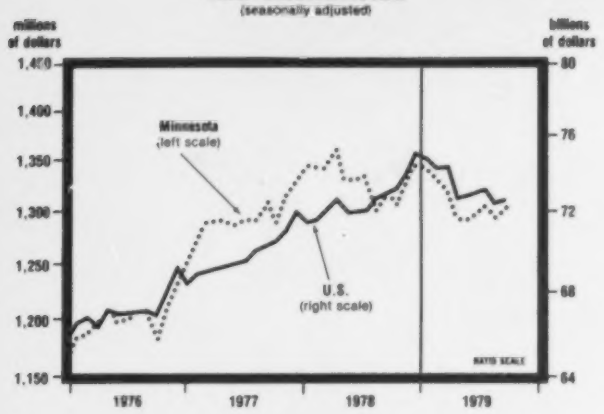




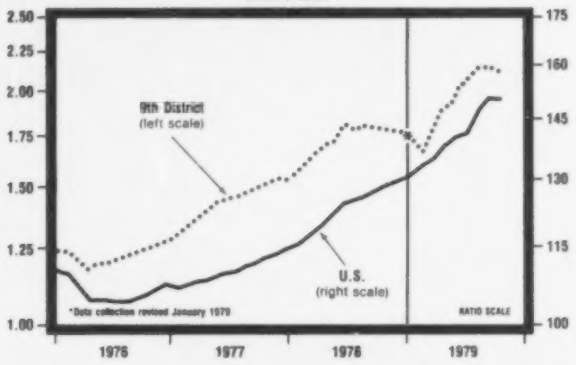


REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME
(seasonally adjusted)

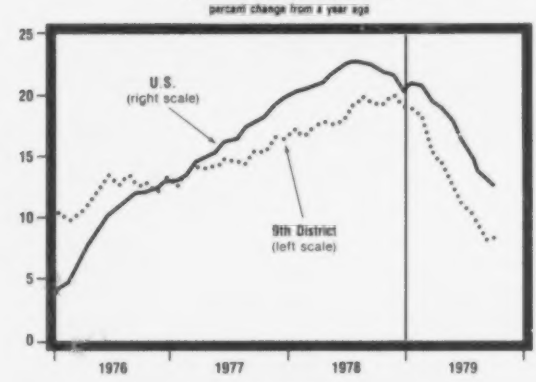


COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS
(seasonally adjusted)
billions of dollars

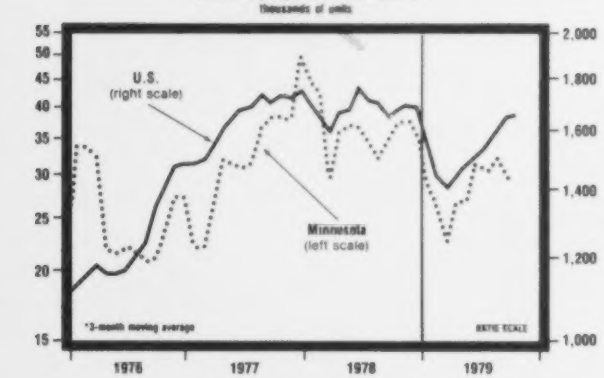


REAL RETAIL SALES
(seasonally adjusted)

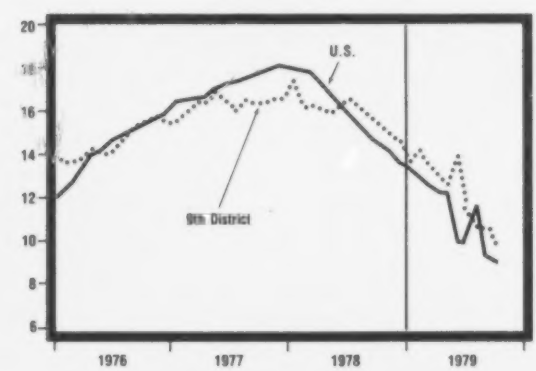
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



HOUSING PERMITS
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units

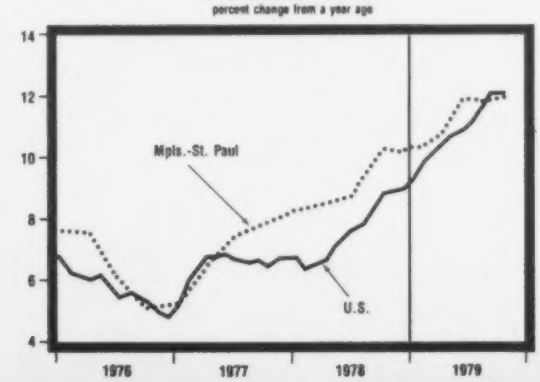


MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force

CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



Dr. Larry J. Wipf

Dr. Larry J. Wipf is an assistant vice president and director of Regional Economics at Northwestern Bank. Prior to joining the bank in March of 1979 as a senior economist, he was an economist with the Bureau of International Affairs of the U.S. Department of Labor where he worked on international trade policy issues. Larry received both his undergraduate degree in Agricultural Business Administration and his graduate degree in Agricultural Economics from the University of Minnesota, and his Ph. D. in Economics from the University of Wisconsin in Madison. A native of southwestern Minnesota, Larry was a vice president of Future Farmers of America and a Regional Star Farmer.

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northwest economic indicators

National Outlook

January 17, 1980

Highlights

- **Another double-digit inflation rate will be with us this year even though the month-to-month trend should improve as the year progresses. Poor productivity performance and accelerating energy costs are the main reasons.**

- **Workers, outside of a few industries with generous cost-of-living clauses, will not be able to keep up with inflation. Their pocketbooks and their confidence will be battered.**

- **President Carter's move to gradually decontrol U.S. oil prices will mean that the price of domestic oil will rise faster than that of imported oil. On the average, the overall cost of crude oil will rise about 50 percent over 1979.**

- **Labor and energy costs will keep food prices moving up. However, agricultural commodity prices should limit food price gains to less than 9 percent this year.**

- **American industries are well poised for the current economic recession. Inventories are lean and labor hoarding is not commonplace.**

- **Industries related to consumer-cyclical, construction, and heavy capital equipment other than computer-related will fare relatively poorly. On the other hand, those industries which make products to improve productivity and cut costs will perform relatively well.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Inflation

Double-digit inflation last year is history now. Prices of lettuce, hamburger, airline tickets, out-of-town lodging, taxi fare, restaurant meals and a lot more have shown double-digit gains. No wonder, a cynic suggested that the Susan B. Anthony Dollar should be called a Lavern and Shirley Quarter.

Are we in for more pleasant tidings in this new year? Maybe. Later in the year, inflationary pressure is expected to moderate. For most of the year, however, prices and taxes will rise faster than consumer's income, battering their purchasing power.

Don't be too disappointed, you may be able to find quite a few bargains. Need a house? Sliding demand as a result of high mortage rates and rising unemployment should slow the rise in home prices. Of course, your new house will need furniture and appliances. Again you are in luck! Weak demand, high inventory costs and heavy competition will produce quite a few good buys.

Don't plan on setting your thermostats above 60 degrees though. Natural gas could cost 15 to 20 percent more this year. Cost of a gallon of fuel oil may hit $1.50 by year-end. Electricity costs will rise up to 10 percent. Despite the rising heating costs, you will be able to keep warm. Thanks to fierce competition from imports and softening demand, clothing may be one of the best buys. So, get several sets of long johns and bundle up!

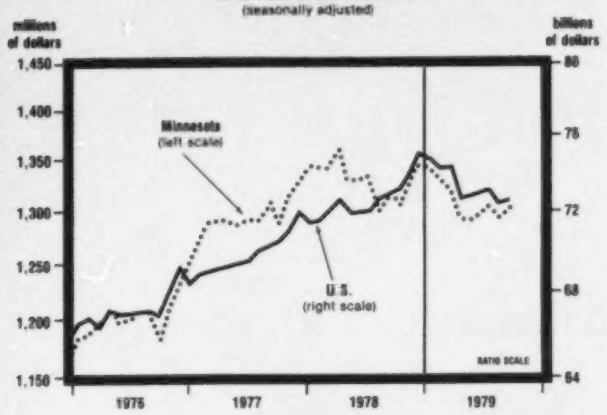
You will need that warm, cozy feeling in your attractively furnished house because you may not be able to go any place. Gasoline for your car and jet fuel for airplanes will cost you dearly. Even if you could get away, lodging and entertainment will bore a hole in your wallet. How about friends and relatives you planned to visit? You may have to settle for long-distance calls. The Bell System says that long-distance rates should not go up very much if at all.

The point of the above discussion is that anything which uses labor and energy will get more and more expensive. A consolation prize is that the weakening economy should produce a few attractive buys. Let's study costs of labor and energy in some detail.

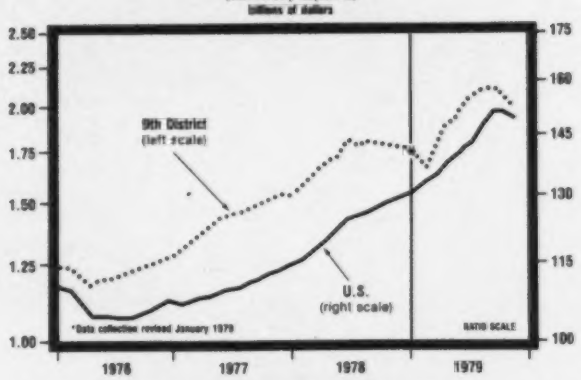
Wages: Three-fourths of costs are traceable to wages and benefits adjusted for any productivity gains. Using economists' jargon, it is called "unit labor costs."

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME
(seasonally adjusted)

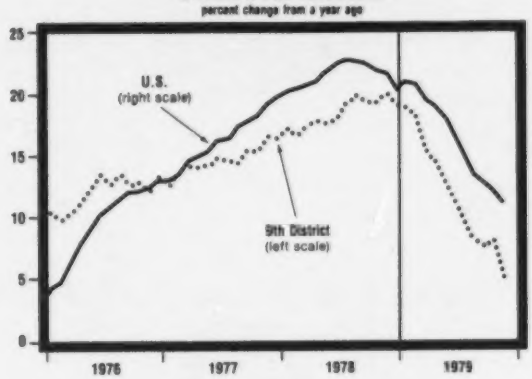


COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS
(seasonally adjusted)
billions of dollars

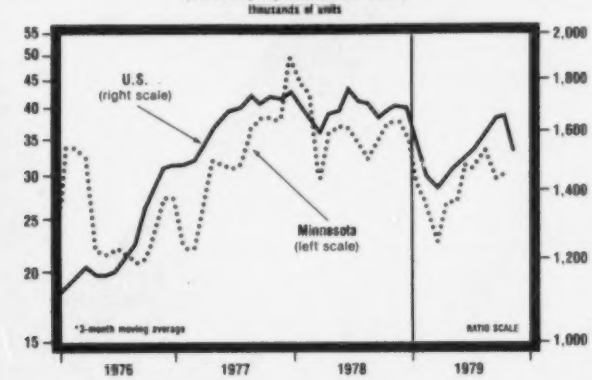


REAL RETAIL SALES
(seasonally adjusted)

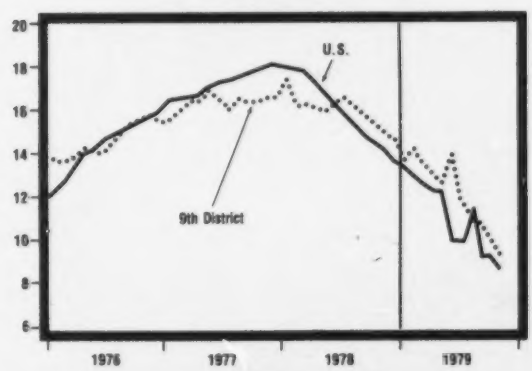
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



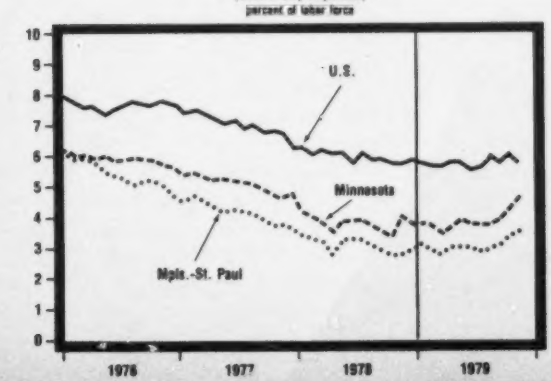
HOUSING PERMITS
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago

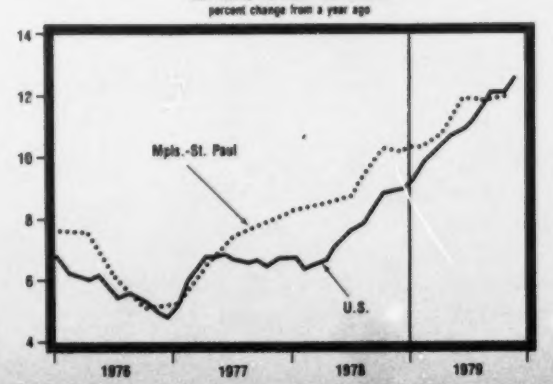


Table I
UNIT LABOR COSTS AND CONSUMER PRICES
(percent change per annum)

	Productivity*	Compensation per hour	Unit Labor Costs**	Consumer Price Index
1948-53	3.6%	6.2%	2.5%	2.2%
1953-58	2.5	4.6	2.1	1.5
1958-63	3.2	4.2	0.9	1.2
1963-68	3.2	5.8	2.5	2.6
1968-73	1.9	7.1	5.0	5.0
1973-78	1.0	8.9	7.8	8.0
1977	1.9	8.0	6.0	6.5
1978	0.5	8.5	8.0	7.7
1979 (estimated)	−1.7	8.0	9.9	11.3
1980 (projected)	−0.9	9.1	9.8	10.8

*Output per hour, private business sector
**Compensation less productivity
Source: Bureau of Labor Statistics, Northwestern National Bank Estimate.

Table I shows a close relationship between unit labor costs and the consumer price index. For example, productivity in the private business sector declined during 1979 while compensation accelerated. The combination of lower productivity and compensation pushed unit labor costs to about 10 percent. Not surprisingly, the average price increase last year roughly paralled the change in unit labor costs.

This year, productivity declines and wage gains are expected to accelerate. Without any help from productivity gains, all wage and benefit increases will go straight into inflation. This is one of the main reasons behind another double-digit price rise this year, even though the price trend should improve toward year-end.

This does not mean that workers will get rich and fat. To the contrary, worker's purchasing power has been falling for quite a while and there is no early prospect that this lost purchasing power will be restored. Only workers in the auto, steel, rubber and a few other industries with generous cost-of-living clauses (COLA) will be able to stay ahead of inflation. For example, auto workers may receive as much as 14 percent wage increases this year. While these contracts get a lot of publicity, they cover only a few million of the nearly 98 million employed Americans.

However, the number of workers protected by COLA may swell as the year progresses. As shown in Table II, over three and a half million private sector employees in major unions are scheduled to negotiate new contracts this year. The major unions include the steelworkers, carpenters and other construction workers, communication workers, and electrical workers. No doubt, the union workers will attempt to and succeed in neutralizing the corrosive impact of inflation on their buying power.

For a majority of workers, three key factors, the unemployment rate, productivity gains and President Carter's pay advisory committee, will prevent wages and benefits from rising as fast as overall price increases.

The rising unemployment rate and slack labor market this year will tend to slow wage increases. In addition, with no productivity gains in the economy, the management is less likely to grant wage increases. The pay advisory committee, which has proposed a 7.5 to 9.5 percent range for wage and benefit increases in 1980, will have a dampening impact on pay increases. In short, compensation gains, which tend to account for a lion's share of inflation, will average about 9 to 10 percent this year.

Table II
MAJOR INDUSTRIES FACING LABOR NEGOTIATIONS

MONTH	INDUSTRY
January	Oil, Chemical and Atomic Workers, Tobacco Workers
March	Glass Bottle Blowers
April	United Steelworkers
May	United Steelworkers, Aluminum Workers
June	Utility Workers
August	Communications Workers of America, Electrical Workers and Telecommunications International
September	International Longshoremen's Association, Amalgamated Clothing and Textile Workers
October	International Association of Machinists, United Auto Workers, Amalgamated Transit Union
December	Seattle Professional Engineering Employees Association, Service Employees International Union

Source: Bureau of Labor Statistics.

Energy: Let us turn to another important source of inflation: energy. Last year, Americans paid about $60 billion for imported oil. This year, the oil bill from abroad will exceed $100 billion. In addition to the skyrocketing price of foreign oil, President Carter's mc to gradually decontrol U.S. oil prices will continue to add costs to all oil-based fuel and products. In fact, Table III shows that domestic oil prices are projected to go up faster than imported oil costs this year.

One benefit of rising energy costs and occasional gas lines has been a reduction in energy demand here at home and abroad. Oil consumption in the United States is running 2 to 3 percent less than a year ago. Gasoline demand fell 7 percent in the second half of 1979, and has been down as much as 10 percent in recent weeks. With higher costs of energy and a worldwide economic slowdown, demand should moderate further.

All these signs of weakening demand and bulging oil stocks led some analysts to believe that the worst energy price hikes may soon be over. This is a pleasant, but unrealistic, thought.

The events in Iran have made a number of oil-producing countries very sensitive to the effects on their political, social, and religious fabrics of the pace of development programs. The general pressure in many of these countries is to reduce oil production and to raise prices. Should the supply of oil be disrupted as a result of political upheavals, the price of imported oil could leapfrog toward the sky.

Barring an unexpected cutoff of oil supply, the 51 percent increase in domestic and crude oil as shown in Table III will reinforce the double-digit increase in the unit labor costs. In short, jumps in energy costs which added 3 percent to inflation in 1979, will continue to play havoc with inflation.

Food: During the first part of last year, food prices made a significant contribution to double-digit inflation. Poor weather was an important reason. No one can tell what Mother Nature will do this year.

Barring a major weather-related problem, processing, marketing and distribution costs account for three-

ECONOMIC OUTLOOK

January 1980

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
	1978	1979E	1980E	1979E				1980E				1978	1979E	1980E
				I	II	III	IVE	IE	IIE	IIIE	IVE			
Consumer Price Index (1967 = 100)	195.5	217.6	241.1	11.1	13.6	12.9	13.0	10.1	8.4	8.9	8.2	7.7	11.3	10.8
Food	211.8	234.6	255.2	15.9	11.3	3.1	9.6	9.9	9.1	8.7	9.8	10.2	10.8	8.8
Nonfood Commodities	174.6	195.3	217.7	11.6	15.3	16.0	15.2	10.8	8.0	8.9	7.5	5.7	11.9	11.5
Services	211.2	233.9	258.4	8.2	13.1	14.3	12.5	9.6	8.4	8.9	8.0	8.6	10.7	10.5
Producer Price Index, Finished Goods (1967 = 100)	194.6	215.6	238.6	13.8	10.4	10.5	12.5	10.9	10.2	9.8	7.9	10.6	10.8	10.7
Compensation Per Manhour Nonfarm Private (1967 = 100)	229.2	247.5	269.9	10.4	8.1	8.6	8.0	10.0	9.3	9.2	9.2	9.2	8.0	9.1
Labor Productivity, Nonfarm Private (1967 = 100)	117.7	115.7	114.7	– 3.0	– 4.0	– 0.7	0.6	– 1.0	– 1.3	– 1.5	1.4	1.1	– 1.7	– 0.9
Unit Labor Costs, Nonfarm Private (1967 = 100)	194.6	213.9	234.9	13.7	12.1	9.4	7.6	11.0	10.1	10.7	7.8	8.1	9.9	9.8
Corporate Profits After Taxes, bil. $	121.5	145.1	134.6	32.7	– 7.4	28.5	7.5	– 16.1	– 29.0	– 5.4	0.0	16.3	19.4	– 7.2
Disposable Personal Income, bil. $ (1)	1458.4	1620.5	1743.3	13.0	7.7	9.9	7.1	4.8	7.0	11.0	10.5	11.7	11.1	7.6
Real Disposable Personal Income, bil. $ (2)	746.0	744.7	723.1	1.7	– 5.9	– 3.0	– 5.9	– 5.3	– 1.4	2.1	2.3	3.7	– 0.2	– 2.9
New Passenger Car Sales (millions of units)	11.3	10.6	8.7	11.6*	10.5*	10.8*	9.4*	8.8*	8.5*	8.5*	9.0*	11.3*	10.6*	8.7*
New Private Housing Starts (millions of units)	2.01	1.74	1.40	1.62*	1.83*	1.83*	1.67*	1.40*	1.30*	1.35*	1.55*	2.01*	1.74*	1.40*
Unemployment Rate, %	6.0	5.8	7.8	5.7*	5.7*	5.8*	5.9*	7.0*	7.9*	8.0*	8.2*	6.0*	5.8*	7.8*
Federal Government Deficit, bil. $	27.7	12.8	55.0	11.7*	7.0*	11.3*	21.0*	36.0*	60.0*	61.5*	62.6*	27.7*	12.8*	55.0*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

ECONOMIC OUTLOOK (Without Inflation)

January 1980

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
	1978	1979E	1980E	1979E				1980E				1978	1979E	1980E
				I	II	III	IVE	IE	IIE	IIIE	IVE			
Gross National Product	1399.2	1430.7	1419.7	1.1	−2.3	3.1	0.9	−3.0	−3.0	−0.4	3.5	4.4	2.2	−0.8
Consumer Expenditures	900.8	922.4	917.6	0.7	−2.9	4.8	0.4	−3.1	−2.0	0.1	2.3	4.5	2.4	−0.5
Durables	146.7	146.1	135.5	−5.2	−13.4	5.7	−11.7	−13.6	−7.0	−1.3	3.9	6.1	−0.4	−7.2
Nondurables	343.3	348.1	345.9	−4.3	−4.4	6.1	2.0	−3.5	−3.2	−0.7	2.3	3.2	1.4	−0.6
Services	410.8	428.3	436.2	7.3	2.4	3.6	3.5	0.9	0.7	1.1	1.8	5.1	4.3	1.9
Investment	214.4	216.1	198.5	−0.5	8.5	−12.8	−5.4	−6.2	−22.8	−3.6	10.8	7.1	0.8	−8.1
Fixed Residential (1)	60.1	56.4	49.3	−14.4	−7.2	−1.0	−10.6	−25.4	−18.8	−2.8	10.9	4.2	−6.1	−12.7
Fixed Nonresidential (2)	140.1	149.4	152.2	4.8	−0.7	10.8	5.4	4.4	1.5	−10.2	−5.3	8.4	6.6	1.9
Structures	43.9	47.9	49.3	−5.9	19.6	6.8	5.0	3.9	2.1	−8.5	−4.6	12.3	9.1	2.8
Producers Durable Equipment	96.2	101.4	102.9	10.1	−8.9	12.2	6.0	4.6	1.2	−11.0	−5.7	6.7	5.4	1.5
Change in Inventories	14.2	10.3	−3.0	12.3*	18.1*	7.1*	3.6*	2.5*	−8.5*	−5.8*	0.0*			
Net Exports (3)	10.9	17.9	25.3	17.0*	13.1*	20.1*	21.6*	21.4*	27.2*	26.0*	26.5*	10.9*	17.9*	25.3*
Exports	108.9	120.2	128.0	117.0*	116.0*	122.2*	125.5*	125.0*	128.9*	128.0*	130.0*	108.9*	120.2*	128.0*
Imports	97.9	102.2	102.7	100.0*	102.9*	102.1*	103.9*	103.6*	101.7*	102.0*	103.5*	97.9*	102.2*	102.7*
Government Purchases	273.2	274.2	278.3	−1.9	−3.2	1.0	5.5	−0.2	1.4	1.8	2.1	1.7	0.4	1.5
Federal	98.6	99.2	101.6	6.9	−11.1	−2.8	12.3	1.5	3.0	2.4	1.5	−2.0	0.6	2.4
State and Local	174.6	175.0	176.7	−6.6	1.6	3.1	2.0	−1.2	0.5	1.5	2.4	4.0	0.2	1.0

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

Table III
CRUDE OIL REFINERY ACQUISITION COST
(dollars per barrel)

	DOMESTIC	% change at annual rate	IMPORTED	% change at annual rate	COMPOSITE	% change at annual rate
1973	$4.17		$4.08		$4.15	
1974	7.18	72.1%	12.52	206.9%	9.07	118.6%
1975	8.39	16.9	13.93	11.3	10.38	14.4
1976	8.84	5.4	13.48	−3.2	10.89	4.9
1977	9.55	8.0	14.53	7.8	11.96	9.8
1978	10.61	11.1	14.57	0.3	12.46	4.2
1979 (Est.)	14.03	32.2	21.78	49.5	17.60	41.3
1980 (Est.)	22.00	56.8	32.00	46.9	26.50	50.6

Source: Department of Energy. Northwestern National Bank Estimate.

fourths of food prices. These costs can be traced to, once again, labor and energy. Given the kind of compensation and wage increases discussed earlier, a sizable increase in food price, regardless of commodity price fluctuations, is almost guaranteed.

The price of agricultural commodities, roughly a quarter of food prices, should have a moderating influence on food prices. The recession's impact on demand for meat will moderate increases in beef prices. Large supplies of pork and poultry will also dampen price rises. Assuming normal weather, prices of vegetables and grains should not increase very much.

If you eat out often, however, there will be little to cheer about. Once again, labor and energy costs will make dining out very expensive.

All in all, food prices in 1980 should record an 8 to 9 percent increase in 1980.

Industry Outlook

Indian summer is a period of mild, warm weather occurring in late autumn. Something along the lines of an Indian summer has been taking place in the economy. But, make no mistake about it, the most advertised, slowest developing recession in history is real.

One benefit of the economic Indian summer is that U.S. industries are well prepared for the current economic downturn. Contrary to the 1973-75 experience, inventories are lean and no significant labor hoardings have occurred. On the other hand, similar to the last recession, demand is softening in the face of double-digit inflation.

Table IV shows the relative impact of the 1973-75 recession on profits of various industries. Will the pattern repeat itself in 1980?

Relative Losers: Industries related to consumer big-ticket items such as automobiles and appliances should fare poorly. Firms supplying to these industries, such as steel, raw materials, etc., will also be impacted.

Construction industry, including residential and nonresidential building, and nonbuilding construction will suffer from high interest rates and a general economic recession. Suppliers to the construction industry, like lumber, steel and other building materials, may face difficult times.

Capital equipment industries, with the exception of high technology and information processing, will begin to feel the recessionary impact. Capital spending is typically a lagging sector of the economy. Therefore, the weakening orders and backlogs will become more pronounced as the year progresses.

Table IV
INDUSTRIES LESS IMPACTED BY 1973-75 RECESSION

Banks	Industrial Machines and Equipment
Computers	Medical Supplies
Containers	Office Equipment
Cosmetics	Oil Service
Drugs	Pollution Control
Electric Equipment and Supply	Printing and Publishing
Electric Utilities	Transportation Equipment
Food—Commodities, Packaged, Distillers	

INDUSTRIES MORE IMPACTED BY 1973-75 RECESSION

Airlines	Nonferrous Metals ex Aluminum
Aluminum	Paper
Apparel	Petroleum
Appliances	Property—Casualty Insurance
Automobiles	Retail Stores
Electronic Components	Steel
Home Furnishing	T.V.—Radio
Lumber	

As was true in 1973-75, airlines will be hit by a double-whammy of high fuel costs and softening passenger traffic. Also, financial institutions, which borrow short and lend long, may have problems since short-term interest rates may remain high by historical standards.

Relative Winners: In addition to the traditionally non-cyclical industries such as food, drugs, medical supplies and utilities, those industries which can make contributions to productivity gains at offices and factories should fare relatively well. Obvious examples are computer-related products, such as softwares, and information processing machines in offices.

Despite their gloomy sales picture, the automobile industry is in the process of retooling to downsize cars. Similarly, the airline industry will continue to expend huge sums to retool. Subcontractors and suppliers to the industries should benefit.

Finally, energy-producing industries will be candidates for good performance. Energy costs will rise substantially, more than offsetting weakening demand for energy. In the area of exploration and drilling for energy, massive sums will be spent benefitting industries in related areas.

Conclusion: Not too many industries will be able to hide from the onslaught of inflation and recession. Overall after-tax corporate profits are expected to decline 5 to 10 percent in 1980. On a trend basis, economic expansion toward year-end should reverse the decline in profits.

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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Economic Dominance

February 21, 1980

Highlights

- **Compared to almost every other industrialized free-world country, the United States is much less dependent on exports for its economic health. In 1977, exports were only 8.3% of our gross national product as opposed to 29.5% for the United Kingdom.**
- **In addition, the large size of the U.S. market combined with the high export dependency of our trade partners means that these other countries are far more affected by economic conditions here than vice versa. For instance, in 1977 our purchases from Canada equalled 17.6% of that country's total output.**
- **Our trading partners' high dependence on foreign markets in general and the U.S. market in particular also means that changes in relative currency values have a far greater impact on economic activity in other countries than in the U.S.**
- **The volatility of the world economic and political climate in the recent past has led more and more to the use of fiscal and monetary policies by foreign governments to moderate the effects of external events on their own economies. This has meant a necessarily reduced role for these policies in controlling domestic economic forces and has been a source of friction between us and our allies.**
- **There is relatively little more these countries can do to control their economic destinies. The main responsibility for a return to a more economically stable world lies with the United States.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

"When the United States sneezes, the rest of the world catches cold." This analogy has often been used to illustrate the powerful effect that the relative health of our economy has on the economic well-being of our trading partners.

In nearly every introductory course in economics, the instructor has chosen to analyze the United States economy as a "closed" economic unit, i.e., a unit in which all economic activity is conducted within its own borders. In other words, any effect on our economy arising through the mechanism of international trade is excluded.

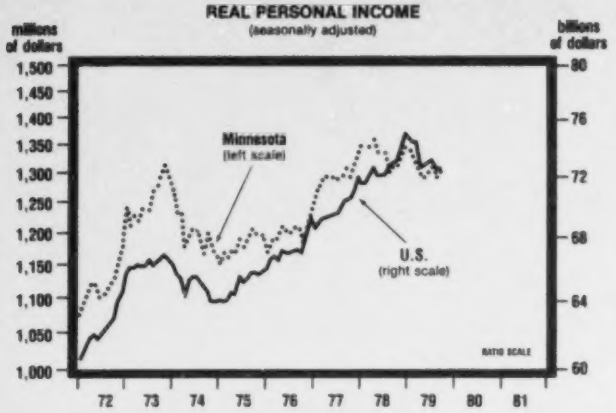
As a device for teaching the basic elements of economics as they pertain to the United States, this exclusion is reasonably justified. The overwhelming wealth of resources of nearly every possible type which lie within our borders does indeed enable us to satisfy the vast majority of our material needs without relying on goods and services produced in other countries. Indeed, if for some reason all international trade should suddenly stop, we as a nation would find adjustments far, far less disconcerting than any of our trade partners.

This certainly is not to say that we don't benefit from trade in the United States--we certainly do! From a comfort and convenience point of view, our lives would be far less pleasant without our Sony televisions and Nikon cameras from Japan or our Volkswagens and Mercedes Benzes from Germany. And, how many of us would like to start the day without a cup of coffee or tea? Moreover, we are all experiencing the definitely uncomfortable effects of uncertainty concerning the future availability and price of imported oil.

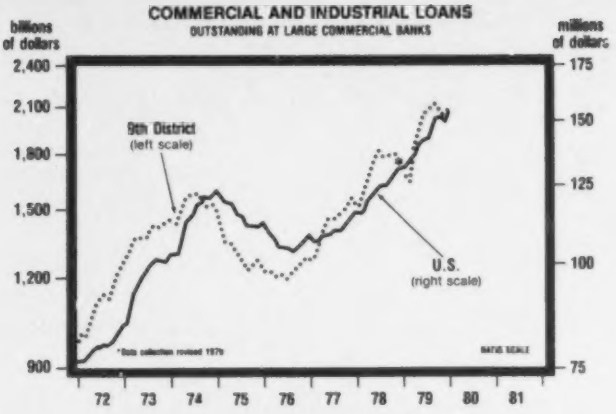
On the selling or exporting side, the recent embargo on trade with the Soviet Union has generated butterflies in the stomachs of many U.S. producers and particularly many of the farmers and agribusiness company managers in our own region. But, the fact remains that these problems are temporary. The grain not sold to the Soviet Union will eventually go to other users. Any lack of imported automobiles, television sets, and cameras would lead, in the U.S., merely to increased production of those goods by our manufacturers, albeit at the expense of the production of other goods which, under the circumstances, U.S. consumers would find relatively less desirable. Also, many goods would be higher priced than they are now.

REGIONAL ECONOMIC CONDITIONS

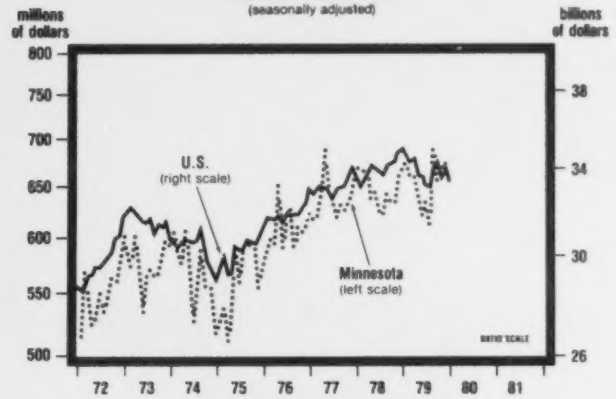
REAL PERSONAL INCOME
(seasonally adjusted)



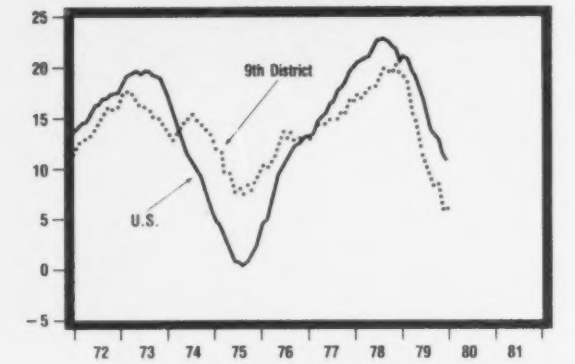
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



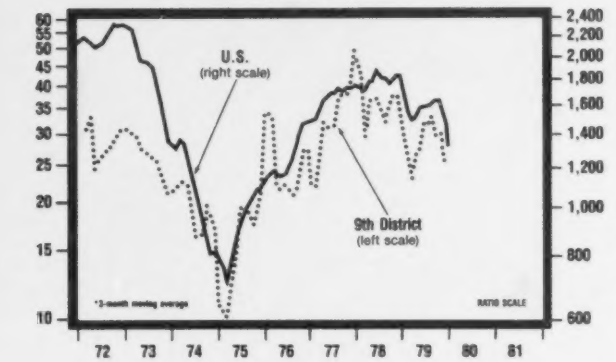
REAL RETAIL SALES
(seasonally adjusted)



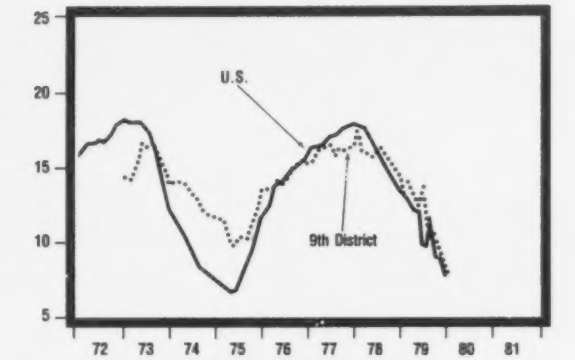
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



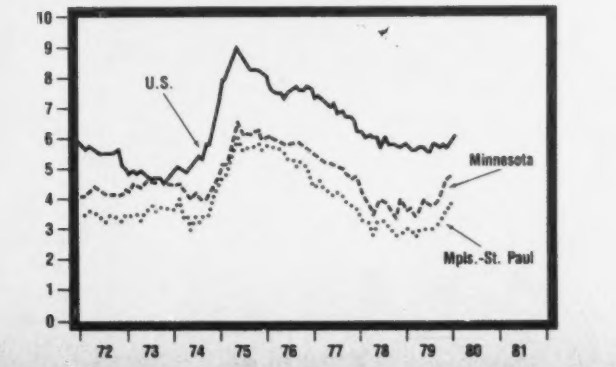
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



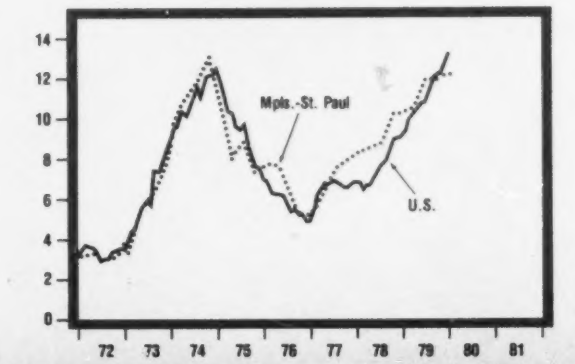
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



The Power

Certainly the United States is fortunate in its high degree of ability to satisfy its own economic demands. But now let's put things in perspective and take a look at how important international trade is to the other major free world industrialized countries.

Table I shows the substantial dependence most other industrialized countries have on foreign countries as generators of their own economic activity. While United States exports as a percent of our gross national product have shown some increase over the last decade, in 1977 we relied on foreign buyers in total to purchase only 8.3% of our output of goods and services. The United Kingdom, on the other hand, sold 29.5% of its output outside its boundaries, while Canada, France, Germany and Italy each had exports equalling 20% to 30% of their gross national product. Only Japan, with an 11.7% exports-to-GNP ratio, now experiences an export independency similar to that of the United States. This is likely to come as a surprise to many due to the high visibility of Japanese-produced consumer goods in our own society.

A major factor affecting the dependency on export markets by any country is the size of its own domestic market. Given the fact that development levels and real living standards do not vary greatly between the countries in Table I, the size of a domestic market may be measured in terms of population. As is shown in the table, no country except Japan has a population (and, therefore, an approximate domestic market) larger than 28% of that of the United States. The large size of the domestic market in the United States and, to a lesser extent, in Japan is a key factor in reducing these countries' dependence on foreign trade. Canada and the major European countries, on the other hand, are forced to sell a substantial portion of their output outside their own domestic markets in order to achieve the economies of scale associated with modern manufacturing technology.

Now that we have seen the heavy extent to which most other industrial countries rely on exports for their economic well-being, let's compare the relative importance of the U.S. market to other countries with the importance of their markets, individually and collectively, to us.

Table II illustrates that, with the exception of Canada, no other major industrial country represents more than seven-tenths of one percent of our total market. Again, excluding Canada the combined portion of our total output in 1977 exported to France, Germany, Italy, Japan and the United Kingdom represented only 1.9% of our production of goods and services. Canada, due to its unique economic ties with the United States, bought 1.8% of our output, or nearly the same amount as the non-North American countries listed above combined. In both absolute and relative terms, demand for the output of goods and services produced in the United States remains very insulated from aggregate demand conditions existing in any single non-U.S. country.

Consider, on the other hand, the importance of the conditions in the United States market to each of the other countries listed. Canada, again due in part to its unique economic closeness with the United States, relied on us to absorb 17.6% of its total output in 1977 while each of the other countries sold anywhere from 1% to nearly 3% of their total output to the United States. Considered in another way, the health of the U.S. economy in 1977 was anywhere from 4.1 times (Japan) to 8.0 times (Italy) as important to the listed non-North American countries as the health of each of their own economies was to us. In the case of Canada, this relative importance factor increased to nearly 10 times.

Moreover, these direct impact figures actually understate to some extent the dependence of the European economies on the United States. Since a very heavy proportion of each of these countries' exports go to each other,

Table I
EXPORT IMPORTANCE, 1977
(billions of U.S. $)

	Gross Nat'l Product	Total Exports	Exports as % of GNP	Population (millions)
Canada	$ 194.3	$ 50.8	26.1%	23.5
France	510.8	101.7	19.9%	53.5
Germany	704.3	190.7	27.1%	61.3
Italy	265.9	65.3	24.6%	56.7
Japan	1,060.1	123.9	11.7%	114.9
United Kingdom	328.5	97.0	29.5%	55.8
United States	2,127.6	175.8	8.3%	218.5

Source: International Monetary Fund, *International Financial Statistics*

Table II
Relative Market Dependency, 1977

	Exports to U.S. as a % of Total Exports	Exports to U.S. as a % of GNP	Imports from U.S. as a % of Total U.S. Exports	Imports from U.S. as a % of U.S. GNP
Canada	67.5	17.6	21.4	1.8
France	5.0	1.0	2.9	0.2
Germany	6.1	1.7	5.0	0.4
Italy	6.7	1.6	2.3	0.2
Japan	24.7	2.9	8.8	0.7
United Kingdom	9.3	2.7	4.5	0.4

Source: International Monetary Fund, *International Financial Statistics* and *Direction of Trade*

anything which has an adverse impact on their own economies will have an adverse impact on other members of the European Economic Community in a proportion approximately equal to their relative market dependence on each other. For example, an economic downturn in the United States would lead not only to a direct reduction in France's exports to us as a result of our direct trade linkage, but also to a reduction in French exports to Germany as a result of weakened demand in that country caused by a reduction in its exports to the United States. The greater relative dependence of each of the European countries on exports in total results in a magnification of both the direct and indirect effects of a change in economic activity in the United States.

The Problems

So what does this all mean? Is the economic health of our trading partners totally dependent upon the wellbeing of our economy? Certainly, this case cannot be argued very strongly. The two devils of inflation and economic stagnation can and are caused by factors indigenous to these countries as well as those outside its scope of immediate control. A desire for increased liquidity on the part of French consumers can lead to decreased consumption expenditures and, consequently, a weakened economy in France as well as in the United States. Pressure for wage increases unaccompanied by corresponding productivity increases on the part of British workers has been a primary cause of that country's high and persistent rate of inflation. No, these countries are perfectly capable, in theory, of exercising the greatest degree of control over their economic fortunes, whether they desire to do so or not. However, given their relatively greater degree of dependence on us than vice versa, distortions in their economies caused by fluctuations in our own economy will require disproportionately large corrective monetary and fiscal policy adjustments on the part of their governments.

Economic management was difficult enough for them under the system of fixed exchange rates which existed from the end of World War II to the early part of the 1970's. During this period, any economic stagnation in the United States tended to depress our real demand for imports which, in turn, led to a direct transmission of our cyclical economic difficulties to Canada, Europe and Japan. Offsetting this impact, however, were the much faster rates of productivity growth overseas, particularly in Europe and Japan in the postwar period compared to the United States, which led to dollar price increases for imported goods far below price increases for comparable U.S.-produced goods. This price advantage tended to support our demand for imported goods even during periods of U.S. economic decline, although this occurred at the expense of a serious deterioration in our balance-of-payments position, particularly during the 1960's.

By 1971, the chronic balance-of-payments deficits on the part of the United States had led to a supply of dollars held outside the United States sufficiently large to be deemed an undesirable surplus and, consequently, the fixed exchange rate system was abandoned.The ensuing period of flexible exchange rates, however, has created new problems for our trading partners and, in many ways, has increased their susceptibility to changes in our own economic climate.

A primary role of flexible exchange rates is to adjust for intercountry price differentials arising as a result of differing rates of inflation. For example, suppose identical automobiles are manufactured in two countries, A and B. At the beginning of 1979, these cars sold for 2,000 pesos (A's currency) in A and 1,000 francs (B's currency) in B, resulting in an exchange rate of 2 pesos for 1 franc. Now, in 1979, inflation in A brings the price of a car there to 4,000 pesos, but stable prices in B result in cars there remaining at a price of 1,000 francs apiece. Fixed exchange rates would result in A's citizens buying all their autos from B, since these identical imported autos, at 2,000 pesos apiece, would now cost only half as much as those produced domestically in A. The result would be a balance-of-trade surplus for B and a deficit for A. If, however, exchange rates were free to adjust, the increased demand for francs by A's citizens to pay for their imported cars would lead to an eventual increase in the franc's price to 4 pesos apiece. At that time, an automobile would cost 4,000 pesos in A whether it was produced there or imported and each country's trade position would again be balanced. Moreover, the real price of autos in each country--one for one since they are identical -- would again be reflected by their respective money prices.

What a pleasant world it could be if everything worked as smoothly as this simple example indicates it should. There is, however, a Mr. Hyde for every Dr. Jekyll and here international economics provides no exception.

Consider the present oil situation. The oil exporting countries have historically priced oil in dollar terms and accepted mainly dollars for payment. But the relatively strong pace of inflation in recent years in the United States has eroded the value of OPEC's dollar receipts and assets in real terms. A strong case can be made that recent sharp OPEC price hikes represent to a large extent a rational attempt to recapture this lost purchasing power. In a sense, we have been exporting our own inflation to other oil importing countries since the dollar price of oil has been rising just as rapidly to them as it has to us. Note also that most other industrialized countries are far more dependent on imported oil than is the United States. While this situation is certainly bad enough from their point of view, the increased demand for dollars to pay for the ever more expensive oil can also, in the absence of other counteracting factors, serve to place downward pressure on their currencies relative to the dollar and further increase the price of oil in terms of their own currencies. To be certain, there are a variety of monetary and fiscal policies which the governments of these countries can institute - and they have done so frequently in the past - to insulate their economies to some degree from these external shocks. However, from their point of view the necessity of using monetary and fiscal policies in a defense against uncontrollable external forces reduces their ability to use these tools to control domestic economic forces.

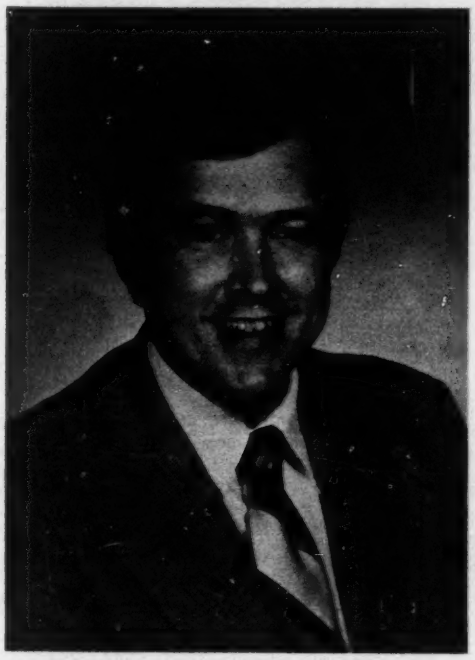
And the Responsibility

What can our trade partners do to minimize the effect on their economies of their susceptibility to and dependence on external markets and events? Unfortunately, very little of substance that they are not already doing. Rather, the onus is now more on us. We have been and continue to be this planet's economic giant, and at no time in our history have economic events here been transmitted overseas with as much force as they are being at present. No wonder that when our leaders request cooperative economic assistance from our overseas allies which they perceive to be detrimental to their interests, their initial response tends more often than not to be less than favorable from our point of view. Inflation control, a comprehensive and realistic energy policy, and the return to a moderate but stable and sustainable U.S. growth path remain the best hope for a return to world economic stability. Surely, if the rest of the world catches cold when we sneeze, it should also be true that good health on our part is transmitted abroad in similar proportions.

Dr. Richard S. Smith
Assistant Vice President
Director of International Economics

Dr. Richard S. Smith

Dr. Richard S. Smith is an assistant vice president and director of International Economics at Northwestern Bank. Prior to joining the bank in October of 1979, he was a senior international economist with Continental Bank in Chicago. He also served as a second vice president and corporate relationship manager in Continental's Multinational Banking Department. Dr. Smith received both his B.B.A. and M.A. degrees from the University of Iowa, and his Ph.D. in Economics from the University of Texas in Austin. While residing in Chicago, Dr. Smith also taught economics at both Roosevelt University and the Keller Graduate School of Management.



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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Regional Outlook

March 24, 1980

Highlights

- During recessionary periods, the Upper Midwest has experienced smaller declines in both nonfarm income and employment than the nation. Although recession-induced declines in economic activity are larger in Minnesota than for the rest of the Upper Midwest, Minnesota is also less affected than the national average.
- This reduced sensitivity to national downturns can be traced to the economic structure of our region. The service sector is the greatest source of stability in our region. This sector accounts for a larger share of our nonfarm employment than nationally. And it continues to grow, although at a reduced rate, during recessions.
- The manufacturing sector also contributes to the stability of our region. This is traceable to the presence of fewer recession-sensitive manufacturing industries such as autos and steel. Even so, our region still experiences significant reductions in manufacturing employment during national economic downturns.
- The construction industry typically has been one of the hardest hit sectors in our region. Much of this volatility is due to housing slumps, which have been at least as severe here as nationally.
- Layoffs in the mining industry tend to be relatively larger in Minnesota than nationally. This reflects the highly cyclical nature of auto and steel production, which in turn adversely affects our taconite industry.
- Rapidly rising production costs and only modestly rising farm commodity prices will cause a sharp reduction in net farm income this year. Thus, agriculture will provide less of a cushion for our region if a national recession develops this year. This is disturbing because the farm sector typically has been a source of regional economic strength.

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Greater Regional Stability During Recessions

The economy has stubbornly refused to slip into a recession. In fact, until the recent sharp jump in interest rates, it appeared that a recession might again be avoided this year. Declining consumer purchasing power would instead reflect itself in a flat or very sluggishly growing economy. While this possibility still exists, it does not bring forth an image of a strong and healthy economy.

Policymakers, however, appear determined to push the economy into a recession. If a national recession does develop, how will our region fare? Which sectors will be most seriously impacted? To help answer these questions, the economic performance of our region during the last five recessions was analyzed. Results are reported for both Minnesota and the regional economy encompassing Minnesota, North Dakota, South Dakota, Montana, Iowa and Nebraska. This region is referred to as the Upper Midwest.

Previous Recessions

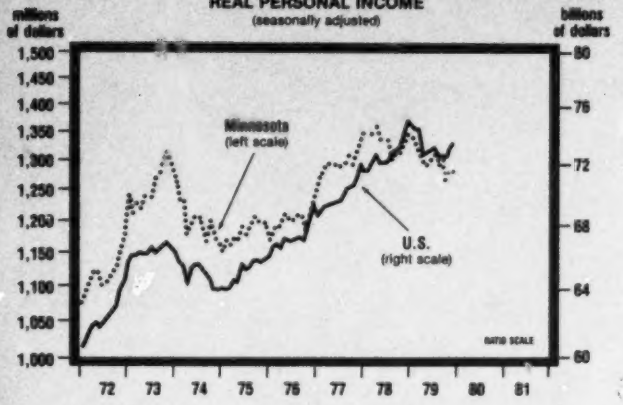
Nonfarm Income: Farm income usually changes independently of the national business cycle. And its volatility often tends to obscure underlying cyclical developments. Thus, nonfarm income is one of the best available measures of overall economic activity in our region.

Table 1 shows that real (i.e., inflation adjusted) nonfarm income in the Upper Midwest region is considerably less sensitive to the business cycle than the rest of the nation. For example, during the last recession, real nonfarm income declined by 1.5 percent in our region compared with a 5 percent decline nationally.

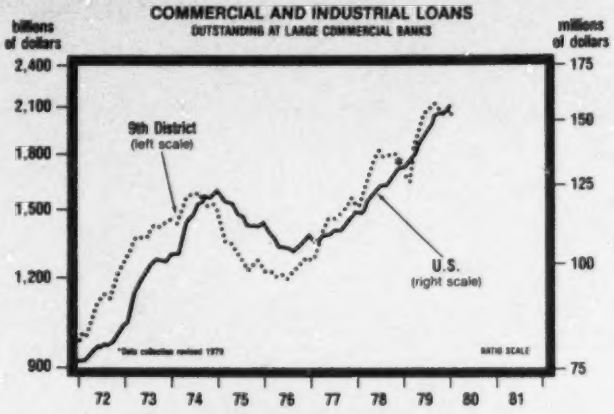
Although less pronounced, a similar pattern emerges for Minnesota. While the 1969-70 recession suggests that Minnesota is more impacted by recessions than the national average, unusual events overstated the impact of that business cycle on Minnesota nonfarm income. During that period, Minnesota was plagued by labor disputes in construction, airline transportation and education; cutbacks in military and aerospace contracts and the permanent closing of a meat

REGIONAL ECONOMIC CONDITIONS

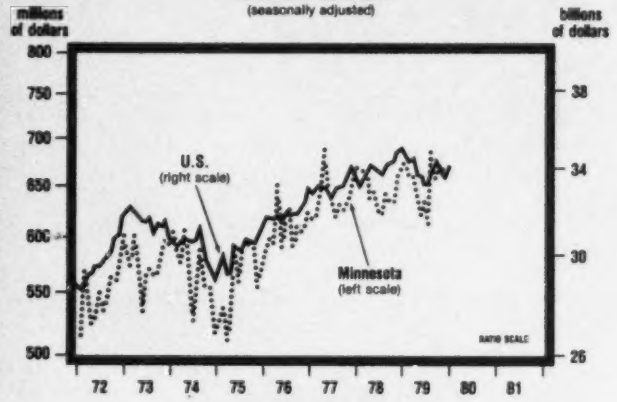
REAL PERSONAL INCOME
(seasonally adjusted)



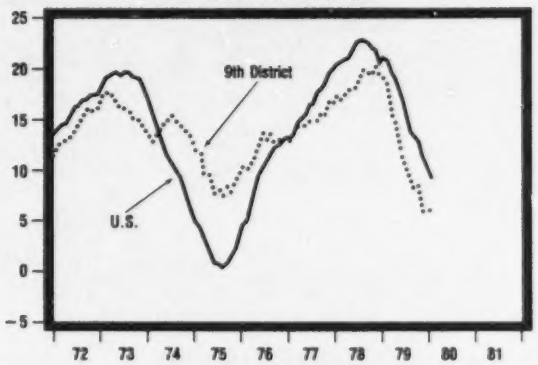
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



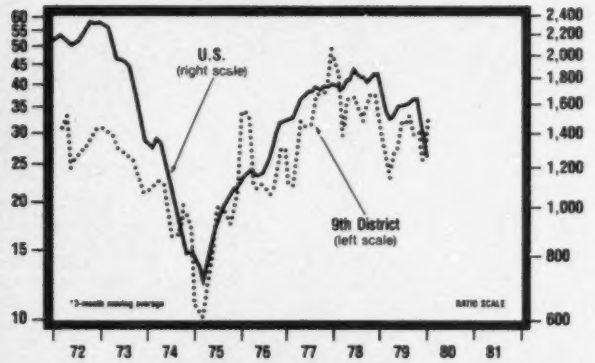
REAL RETAIL SALES
(seasonally adjusted)



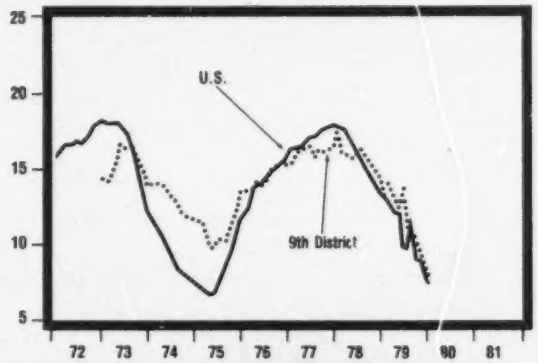
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



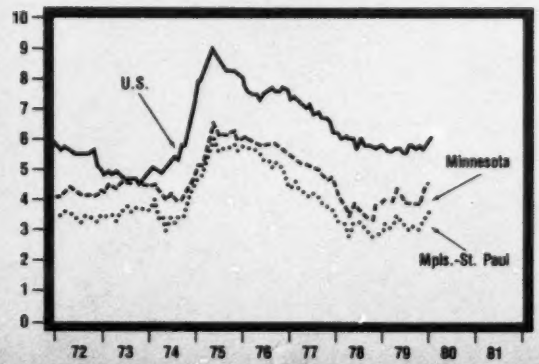
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



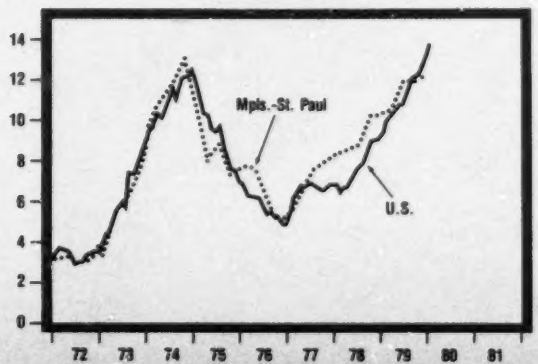
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



packing plant. Thus, the 1969-70 experience should be viewed as an exception rather than a general rule.

Nonfarm employment: Other indicators of economic activity also reveal the greater resilience of the Minnesota and regional economy during national recessions. As shown in Table 2, recession-induced declines in total nonfarm employment typically have been between one and two percentage points less in the Upper Midwest than the nation. As a result, unemployment rates rise significantly less in our region than nationally.

Relative to the national average, Minnesota's nonfarm employment is also more stable during recessionary periods. As discussed earlier, the 1969-70 exception to this conclusion can be explained by a series of special factors which overstate the impact of that recession on Minnesota. Note, however, that the recession-induced declines in employment are larger in Minnesota than for the Upper Midwest region.

Table 3 reveals that the major source of employment stability in our region comes from the service sector which accounts for over 40 percent of our nonfarm employment. Among others, this segment includes finance, insurance, medical and government services. During the past five recessions, employment in these service industries continued to grow, although at a slower pace. Furthermore, the growth rates for Minnesota and the Upper Midwest region exceeded the national average.

Another service sector, wholesale and retail trade, also adds to employment stability. During recessions, employment in wholesale and retail trade has tended to fall only modestly throughout the nation, with a small edge given to our region. This relatively stable sector accounts for around one-quarter of our nonfarm employment, a greater share than the national average.

The manufacturing sector is the second largest contributor to the relative stability of our region. During the past five recessions, manufacturing employment declined by an average of 7.2 percent in the Upper Midwest, 8.8 percent in Minnesota and 9.3 percent for the nation. These differences are even more pronounced if the 1969-70 recession is excluded.

The relatively smaller decline in our region is traceable to the presence of fewer recession-sensitive manufacturing

Table 1
Real Nonfarm Income During Recessions[a/]

Recession	Peak to Trough Decline in Nonfarm Income		
	United States	Minnesota	Upper Midwest
	(Percentage change)		
1960-61	-1.1	-0.4	+1.1[b/]
1969-70	-1.2	-2.1	-0.9
1973-75	-5.0	-3.4	-1.5

[a/] Nonfarm income includes wages, salaries and business income paid to individuals. Dividends, interest, rents and transfer payments are excluded. Data are adjusted for inflation.
[b/] Average income growth during the recession.

Table 2
Total Nonfarm Employment During Recessions

Recession	Peak to Trough Decline in Employment		
	United States	Minnesota	Upper Midwest
	(Percentage Change)		
1953-54	-3.5	-2.6	-1.6
1957-58	-4.3	-2.5	-2.1
1960-61	-2.2	-1.6	-1.0
1969-70	-1.5	-2.6	-0.9
1973-75	-2.9	-2.4	-2.0

Table 3
Impact of Recessions on Nonfarm Employment

Industry	Peak to Trough Percent Change in Employment		
	United States	Minnesota	Upper Midwest
	Average for Recent Recessions[a/]		
Mining	-10.2	-22.8	-15.7
Construction	-10.8	-9.7	-8.1
Manufacturing	-9.5	-8.0	-6.8
Transportation & Utilities	-6.2	-8.7	-5.6
Wholesale & Retail Trade	-1.7	-1.5	-1.2
Finance, Services, Government[b/]	+2.6	+3.2	+2.9
Total Nonfarm	-3.2	-2.3	-1.7
	1973-74 Recession		
Mining	-4.6	-11.2	-7.2
Construction	-19.2	-15.1	-12.9
Manufacturing	-11.5	-11.2	-10.6
Transportation & Utilities	-5.2	-7.4	-5.2
Wholesale & Retail Trade	-1.5	-1.3	-0.9
Finance, Services, Government[b/]	+3.1	+3.4	+3.6
Total Nonfarm	-2.9	-2.4	-2.0

[a/] Recession Periods are: 1953-54; 1957-58; 1960-61;1973-75. The 1969-70 recession was excluded due to a series of unusual events which tend to distort the Minnesota results.
[b/] Average Employment Growth during the recessionary periods.

industries such as automobiles and steel. Even so, in absolute terms, our region still experiences significant reductions in manufacturing employment during national economic downturns.

In previous recessions, the construction industry has been one of the most volatile sectors in the region with peak to trough declines in employment averaging about 10 percent in Minnesota and 8 percent in the Upper Midwest. This compares with an average decline of 11 percent for the United States. Much of this volatility, of course, is due to the cyclical nature of residential construction.

Employment in mining, our region's smallest sector, is also quite volatile. In fact, layoffs in the mining sector are relatively larger in our region than nationally. This largely reflects the cyclical nature of auto and steel production, which in turn causes sharp reductions in taconite production and employment in northeastern Minnesota. Even though still quite volatile, Minnesota mining employment has declined less sharply in recent recessions than during the fifties and early sixties.

Employment in transportation, communications and public utilities is also significantly affected by national recessions, with employment declining relatively more in Minnesota than nationally. This may, in part, reflect reduced production and shipments of iron ore.

Residential construction: Homebuilding traditionally has been hard hit by recessions and related credit crunches. As shown in Table 4, the housing slump typically is at least as severe here as nationally. This may, in part, simply reflect the greater volatility of home-building within any one small segment of the country. In addition, the declines in our region typically have been from unusually strong peaks. The large declines in our region may also reflect the possible adverse effects that previous usury laws had on the availability of mortgage funds in this region during periods of high interest rates.

Table 4
Homebuilding Activity During Recessions

Recession	Peak to Trough Decline[a/]		
	United States	Minnesota	Upper Midwest
	(Percentage Change)		
1960-61	-25.1	-35.1	-23.6
1966-67[b/]	-43.8	-61.5	-57.1
1969-70	-24.6	-48.9	-35.8
1973-75	-69.1	-68.4	-57.3

[a/] Percentage change in homebuilding as measured by residential building permits authorized.
[b/] Slump in homebuilding induced by credit tightening. This period was not classified as an economy-wide recession.

1980 Regional Outlook

If a national recession materializes this year, history suggests that the economic downturn in Minnesota and the Upper Midwest should be moderated by the economic structure of our region. In addition, the magnitude of the regional downturn is expected to be milder than the 1973-75 recession, simply because the national downturn is likely to be less severe.

Even so, we will experience our share of economic turbulence in 1980. Retail sales are expected to slacken from their 1979 levels. Housing starts will experience a steep slide and unemployment rates could show definite upward movement by the end of the year.

Homebuilding probably will be one of the most seriously affected sectors in our region. In Minnesota, residential building permits declined by more than 20 percent last year. The combination of high mortgage rates and reduced availability of funds will cause homebuilding to slide further this year, with the peak to trough decline possibly approaching 50 percent.

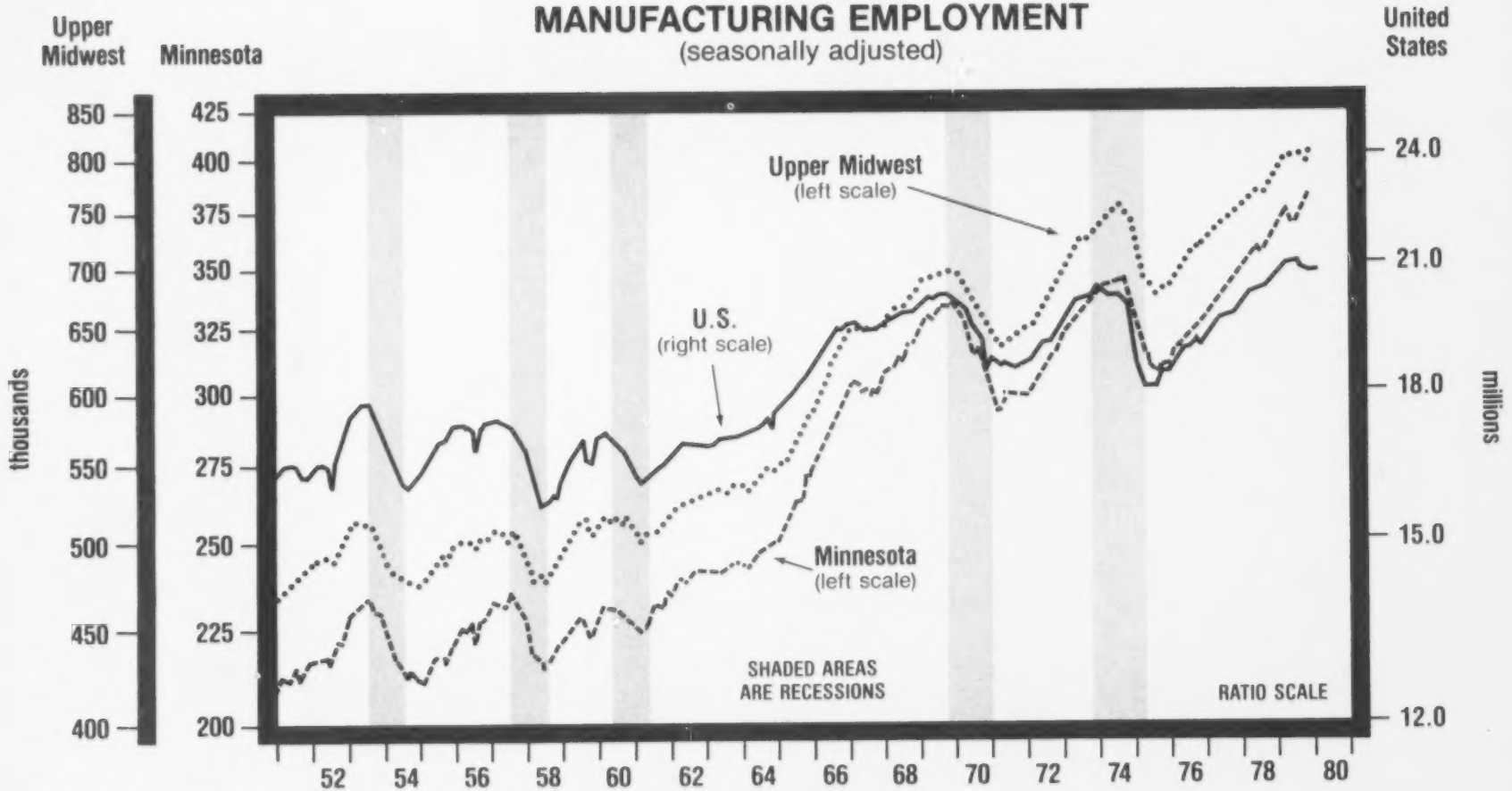
Accordingly, construction employment will also be depressed in our region. However, the current boom in commercial construction in the Twin Cities area will help buffer the decline so that, overall, construction employment may fall significantly less than in previous recessions.

The development of oil and gas resources in North Dakota and Montana should help maintain employment and growth in that portion of the Upper Midwest. On the other hand, sizable declines are expected in taconite production and employment in northeastern Minnesota due to depressed demand for autos and steel. Keep in mind, however, that the steel workers will begin negotiating a new contract next summer. The threat of a strike could significantly alter production and employment estimates for 1980.

Manufacturing employment, especially in the durable consumer goods area and in the lumber and wood products industry, may also decline this year. Nevertheless, the overall decline in manufacturing employment will be cushioned by pent-up demand for electronic components, auto retooling and expansion of aerospace production.

Unfortunately, the agricultural sector will be less of a cushion during this downturn. This year, farm production costs are expected to rise more rapidly than farm revenue. As a result, net farm income could fall by over 20 percent after adjustment for inflation.

This is disturbing because the farm economy has been counted on as a source of regional economic strength. In the past, national economic downturns were barely noticeable in many rural communities. This year, the slowdown in farm spending, not the national recession, will impact a number of rural communities. As a result, although Minnesota and the Upper Midwest will continue to be less impacted by a cyclical downturn than many other parts of the country, this regional difference might be less pronounced if a recession occurs this year.


MANUFACTURING EMPLOYMENT
(seasonally adjusted)
Upper Midwest
Minnesota
United States
thousands
millions
850
800
750
700
650
600
550
500
450
400
425
400
375
350
325
300
275
250
225
200
24.0
21.0
18.0
15.0
12.0
Upper Midwest
(left scale)
U.S.
(right scale)
Minnesota
(left scale)
SHADED AREAS
ARE RECESSIONS
RATIO SCALE
52
54
56
58
60
62
64
66
68
70
72
74
76
78
80

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northwest economic
indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Economy In The Eighties

April 17, 1980

Highlights

- **The degree of uncertainty in the economy is unprecedented. Under the circumstances, conservatism, caution and risk management should be the byword of the day.**
- **Three key mistakes — excessive government spending, over-regulation and excessive reliance on foreign oil — must be corrected before the nation begins to turn around the dismal economic trend.**
- **A strong national leadership, which can rally the citizens to bite the bullet, will be crucial to make things happen. Therefore, the upcoming national election will significantly influence the economic and social well-being of the 1980s.**
- **The economy will continue on a journey of high inflation and low growth for the moment. Capital shortages and crowding out in credit markets may become prevalent. Maturities in debt markets will continue to shorten.**
- **Toward the latter part of the 1980s, a good case for an optimistic scenario can be made. The "taxpayer's revolt" is spreading, favoring efficiency in government. The public now views reducing inflation as the nation's top priority. For the first time, Americans are convinced of an energy crisis. Washington will heed the changing mood of the country toward fiscal conservatism.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

The "Nifty Fifties," the "Soaring Sixties" and the "Sour Seventies" are behind us. What will the next decade be like? Will it be the "Euphoric Eighties" or the "Awful Eighties?"

Social, economic and political changes over the last quarter century have exceeded the expectations of even the most radical seers. Two states have joined the union. Government spending has increased from $70 billion to over $600 billion. Inflation rates have shot up to double-digit annual rates from less than one percent. The prime and high quality corporate bond rates have jumped from about a three percent range to lofty levels. Prices of oil and gold have shown quantum jumps.

There have been other significant structural changes in the economy. The baby-boom generation, which has only heard about the "Great Depression," has gotten accustomed to prosperity and an ever-rising standard of living. A day's pay for a day's work is no longer good enough. The new generation demands job-satisfaction and participation in the decision-making process as well. More recently, they spawned the "Taxpayer's Revolt."

American males are now playing a less dominant role in the society. Back in 1954, males accounted for almost 70 percent of the work force; now the share is down to 58 percent. The economy has become more service-oriented than ever before, with about half of all jobs now in service industries as opposed to 38 percent back in 1954.

Where Did We Go Wrong?

After a quarter-century of accelerating inflation, "outraged, apprehensive, resigned, frustrated, turned-off, cynical, and bitter" are some of the adjectives that some public opinion analysts have used to describe the mood of America today. In other words, inflation has not only hurt pocketbooks but, even worse, has weakened our social fabric and has eroded confidence in our economic system. Inflation is much more than an economic question, it is a social and political question as well. Not surprisingly, inflation has become the nation's number one concern.

Our first mistake was to allow government spending and deficits to balloon. As shown in Chart 1, Federal spending hovered slightly below 20 percent of GNP from the Korean War until 1965. With deep involvement in the Vietnam War, the share began to climb and by 1975 the Federal Government was spending an amount equivalent to 23.5 percent of GNP.

CHART 1

FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES AS A PERCENT OF GNP

(seasonally adjusted annual rates)

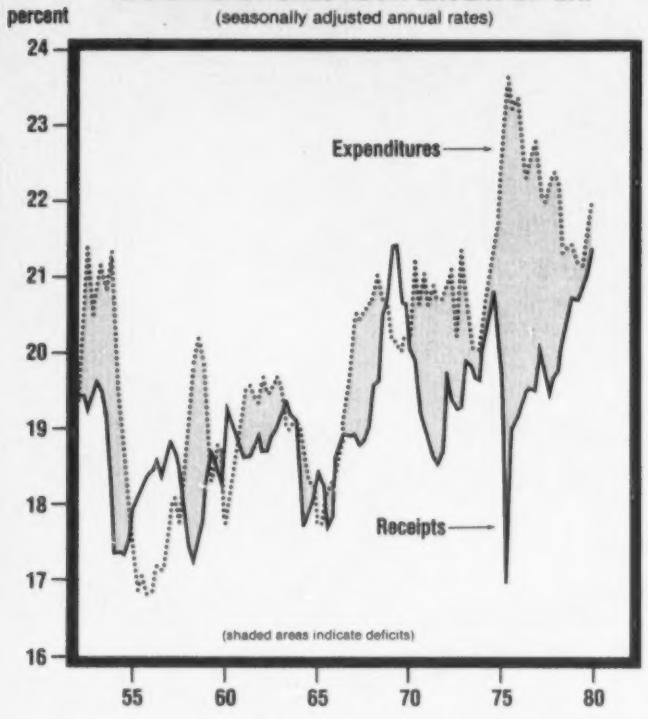


CHART 2

DEFENSE AND NONDEFENSE EXPENDITURES AS A PERCENT OF GNP

(seasonally adjusted annual rates)

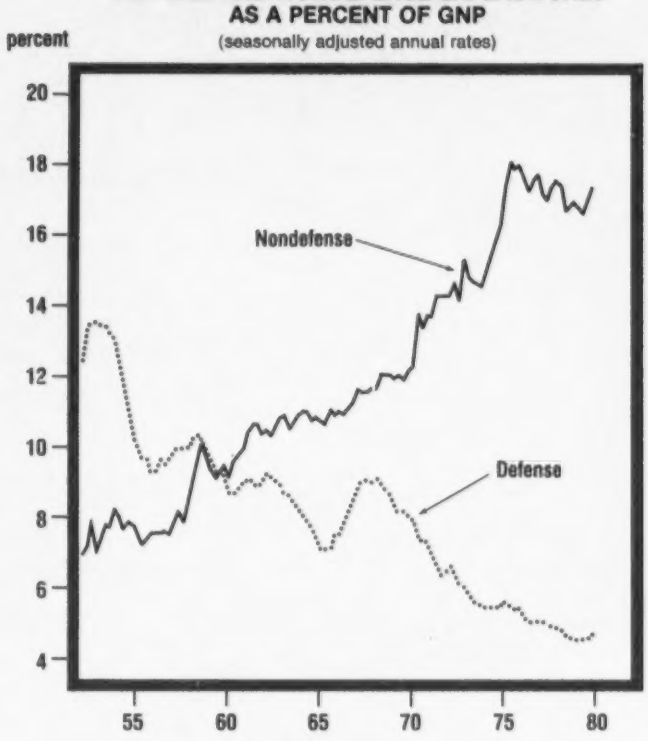


CHART 3

FEDERAL GRANTS-IN-AID AND THE STATE AND LOCAL GOVERNMENT SURPLUS

(seasonally adjusted annual rates)

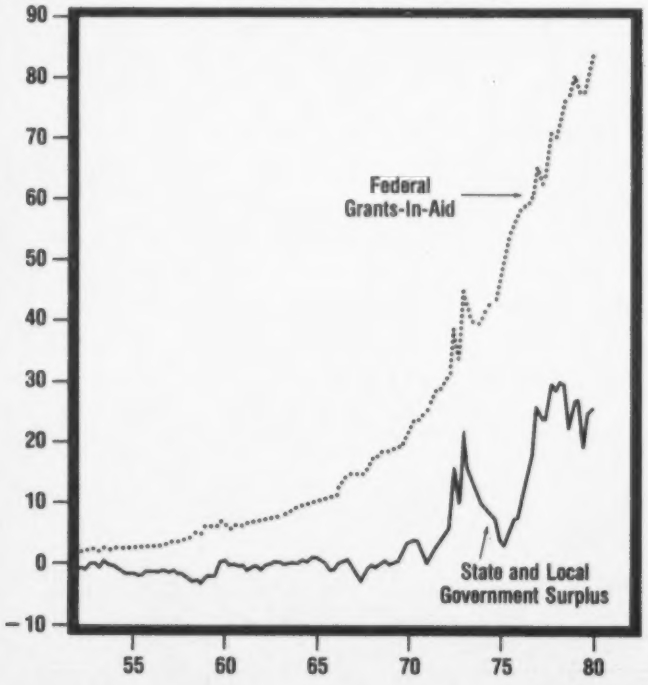
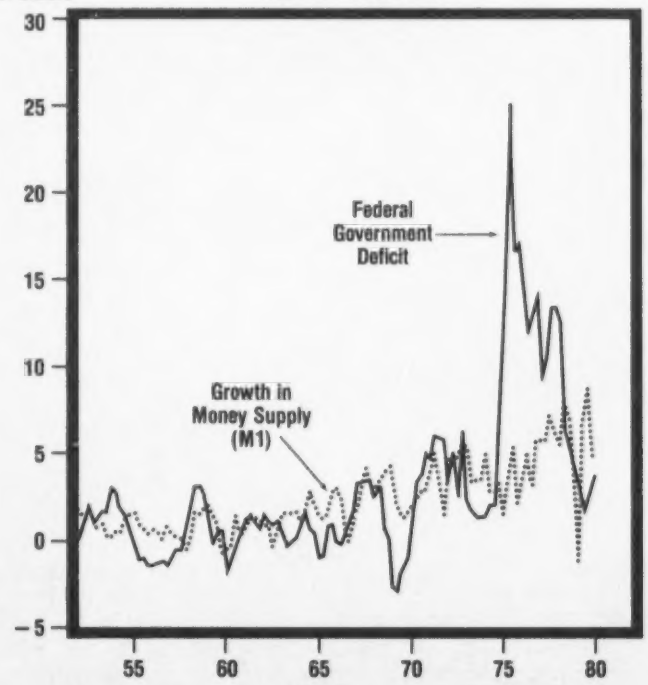


CHART 4

MONEY SUPPLY GROWTH AND THE FEDERAL DEFICIT

(seasonally adjusted)



Since then the ratio has plateaued at about 22 percent. In the process, the national debt has approached a trillion dollars.

To compound inflation problems, the composition of government spending changed. In the 1950s and early 1960s, while social security, public housing and other programs were important, the Federal Government concentrated mainly on defense-related activities. Technology and industrial development benefited heavily from this.

In the mid-1960s, government spending shifted dramatically toward social programs (Chart 2), which were paid for by printing money and redistributing income. State and local governments were put on the Federal dole by a myriad of grant programs for urban redevelopment, mass transit, water pollution and social service programs (Chart 3). The inflationary spiral was institutionalized by the indexing of social security and other benefits to the consumer price index. Although numerous well-meaning citizens have pointed out the need to kick the liberal spending habit, the fact of the matter is that over 50 percent of the population now depends on spending by governments for a significant part of their income.

In order to support Federal Government largess without crowding out too many other borrowers from the credit markets, the Federal Reserve has financed the deficit (Chart 4). Over-expansion of money and credit led to the ratcheting upward of inflation in the 1970s. Periodic attempts by money managers to restrain the inflationary spiral have meant wide swings in interest rates and business activity.

Our second mistake was to allow government regulations to mushroom. Regulation has become a hydra-headed monster telling us "what to do," "when to do," and "how to do." With excessive government regulations in the face of accelerating Federal spending, business investment has failed to keep pace with the economy's needs. Private productivity growth in the 1970s dropped to half the rate of the 1950s and 1960s.

Our third mistake was the failure to grasp the reality that oil supplies are no longer plentiful and cheap. Americans have gotten used to wasting energy. Ten years ago the U.S. imported only 3.4 million barrels of crude oil per day and paid $3 billion in total for it. Last year we imported about 8 million barrels per day and spent about $60 billion for it.

Where Next?

There are three alternative paths to consider. The first is to assume that the future will be more of the same. The only tool a planner then needs is a straight ruler to extrapolate the past trend. This approach may seem simplistic, but the probability of "more-of-the-same," at least in the foreseeable future, is reasonably high.

Second, the economy may be near one of those historical turning points. A stagnating economy plagued with double-digit inflation is not the ideal setting for making optimistic statements about the future. Nevertheless, there are sound reasons for believing that better times may be ahead of us. When the world seems to be coming to an end, that might be the time to be cheerful.

Finally, one can assume that the world has changed so much that the past provides absolutely no guide to the future. Anything can happen. There is too much uncertainty to plan for anything. In this case, conservatism, caution and the minimization of risks should be the byword of the day until a clear trend emerges.

How the economy will actually unfold in the future will depend on our willingness to correct the three mistakes discussed earlier. In this regard, the kind of leadership the nation has in the future will be crucial. The upcoming Presidential election may determine the shape of the economy, not only for the next four years, but for the next decade!

Optimistic Scenario

A year ago we presented a case for an optimistic scenario for the 1980s. The reasons presented in the last April issue of *"Indicators,"* we believe, remain valid.

The opening salvo of economic change was fired in California. Since then, taxpayers in states including Nevada, Idaho, Arizona, Michigan and Texas have moved in similar directions. Some thirty state legislatures have called for constitutional conventions to require balanced budgets. Also, numerous bills have been introduced in Congress to limit government spending and/or taxes. If the movement continues, as seems likely, the nation will have more efficient and downsized governments.

Second, the public, especially the baby-boom generation, now recognizes that the government cannot be everything to everyone and views reducing inflation, not job creation, as top priority. Our legislators and leaders will reflect the mood of the country in setting economic policy toward the goal of reducing inflationary pressure. Incentives for increased business investment will be provided, eventually contributing to productivity gains and economic growth. Government regulation will be reassessed, sharply curtailed and, in some cases, rolled back or abolished.

Third, the gas lines and skyrocketing fuel prices have convinced the electorate that the energy crisis is real. Reflecting the desire of the electorate, Washington will gradually take actions necessary for energy efficiency, conservatism and the development of alternative energy sources. Increased production will combine with slowing consumption to reduce the nation's dependence on foreign oil.

Pessimistic Scenario

Despite the growing disenchantment with big government and big spending, which have nurtured inflation and starved incentives to save and invest, old habits are hard to kick. Consequently, the economy now embarks on a long-term journey of high inflation and low growth. The 1970s prove to have been "the good, old days." Federal deficits mount and the Federal Reserve speeds up the printing press. Periodic less-than-effective attempts by the Federal Reserve to rein in monetary growth and inflation contribute to further instability in the economy.

Financial Markets: A combination of stagflation and the stop-go monetary policy ratchets interest rates upward. With increasing uncertainty and instability, perceived risks in the financial markets increase. Inflation and risk premiums rise. The futility of "saving for a rainy day" is recognized and savings rates are depressed. Investor confidence remains at a low ebb. A growing number of savers bypass financial intermediaries and put existing savings directly into "safe" investments like Treasury bills, gold and silver.

Capital shortages in credit markets become chronic, with lesser quality borrowers shut out either by high interest rates or credit rationing. Young and innovative growth companies do not get a chance to prove themselves. Maturities in debt markets continue to shorten as investors fear further erosion of purchasing power, greater risk of price volatility and default.

ECONOMIC OUTLOOK
April 1980

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
				1980E				1981E						
	1979	1980E	1981E	IE	IIE	IIIE	IVE	IE	IIE	IIIE	IVE	1979	1980E	1981E
Consumer Price Index (1967 = 100)	217.6	251.3	280.9	16.8	18.5	16.4	11.9	10.5	10.2	10.0	10.2	11.3	15.5	11.8
Food	234.9	253.7	279.1	6.5	8.0	9.0	10.0	10.8	10.6	9.5	10.0	10.9	8.0	10.0
Nonfood Commodities	195.0	228.5	261.0	16.5	21.6	20.0	15.5	12.8	11.9	11.7	11.5	11.7	17.2	14.2
Services	234.4	273.4	301.8	19.1	20.4	16.4	9.6	8.5	8.5	8.8	9.2	11.0	16.6	10.4
Producer Price Index, Finished Goods (1967 = 100)	216.0	249.2	282.6	17.6	17.7	15.1	13.9	13.1	12.3	12.3	12.1	11.0	15.4	13.4
Compensation Per Manhour Nonfarm Private (1967 = 100)	247.6	271.4	301.5	9.9	10.0	10.2	10.5	11.9	11.5	11.3	11.1	9.0	9.6	11.1
Labor Productivity, Nonfarm Private (1967 = 100)	115.6	113.4	112.7	−1.6	−3.0	−3.1	−1.2	0.0	0.5	0.7	1.1	−1.1	−1.9	−0.6
Unit Labor Costs, Nonfarm Private (1967 = 100)	214.3	239.0	266.8	11.5	13.0	13.3	11.7	11.9	11.0	10.6	10.0	10.2	11.5	11.7
Corporate Profits After Taxes, bil. $	144.5	138.5	142.0	2.5	−23.4	−16.6	−10.2	7.5	15.4	21.6	27.5	19.0	−4.2	2.5
Disposable Personal Income, bil. $ (1)	1624.2	1779.5	1951.1	13.1	6.1	5.9	10.9	7.9	11.1	13.6	11.5	11.4	9.6	9.6
Real Disposable Personal Income, bil. $ (2)	746.4	703.3	686.6	−3.7	−12.4	−10.5	−1.0	−2.6	0.9	3.6	1.3	0.1	−5.9	−2.2
New Passenger Car Sales (millions of units)	10.7	9.2	9.6	10.2*	8.8*	8.6*	9.1*	9.3*	9.4*	9.7*	10.0*	10.7*	9.2*	9.6*
New Private Housing Starts (millions of units)	1.72	1.07	1.43	1.31*	1.07*	0.99*	0.91*	1.15*	1.35*	1.55*	1.65*	1.72*	1.07*	1.43*
Unemployment Rate, %	5.8	6.8	7.7	6.1*	6.8*	7.0*	7.2*	7.6*	7.7*	7.8*	7.5*	5.8*	6.8*	7.7*
Federal Government Deficit, bil. $	11.2	24.7	3.8	17.0*	11.8*	34.6*	35.2*	8.1*	−2.0*	4.5*	4.5*	11.2*	24.7*	3.8*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

ECONOMIC OUTLOOK (Without Inflation)

April 1980

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
	1979	1980E	1981E	1980E IE	1980E IIE	1980E IIIE	1980E IVE	1981E IE	1981E IIE	1981E IIIE	1981E IVE	1979	1980E	1981E
Gross National Product	1431.6	1419.8	1431.6	2.6	−5.0	−7.4	−2.6	5.4	3.7	3.5	3.0	2.3	−0.8	0.8
Consumer Expenditures	924.5	930.0	932.5	4.8	−6.5	−3.5	−0.6	0.5	3.8	2.4	2.2	2.6	0.6	0.3
Durables	147.1	141.6	143.6	3.1	−13.4	−9.8	−5.0	4.6	12.5	7.6	5.2	0.3	−3.7	1.4
Nondurables	349.1	348.2	346.6	2.5	−11.4	−3.5	2.0	−1.5	3.2	0.5	1.5	1.7	−0.2	−0.5
Services	428.3	440.1	442.3	7.3	0.0	−1.5	−1.2	0.9	1.6	2.3	1.7	4.3	2.8	0.5
Investment	215.2	189.8	195.2	−4.8	−7.9	−34.1	−18.5	42.4	7.3	16.1	9.4	0.4	−11.8	2.8
Fixed Residential (1)	56.6	48.3	47.7	−22.2	−23.1	−20.0	−10.0	2.7	15.7	10.2	10.9	−5.7	−14.8	−1.2
Fixed Nonresidential (2)	148.8	147.0	142.0	1.0	−2.0	−12.6	−8.8	−1.2	1.0	1.2	1.2	6.2	−1.2	−3.4
Structures	48.1	49.2	48.0	−1.0	−2.1	−6.5	−6.5	−1.5	0.3	0.7	1.5	9.6	2.1	−2.4
Producers Durable Equipment	100.7	97.8	94.0	2.0	−1.9	−15.5	−10.0	−1.0	1.4	1.5	1.1	4.6	−2.8	−3.9
Change in Inventories	9.7	−5.5	5.5	1.9*	1.8*	−10.5*	−15.0*	1.0*	2.3*	8.0*	10.8*	9.7*	−5.5*	5.5*
Net Exports (3)	17.7	21.8	24.6	19.8*	21.2*	22.3*	23.2*	24.4*	24.9*	24.1*	24.9*	17.7*	21.6*	24.6*
Exports	120.0	124.9	128.6	125.1*	125.2*	123.8*	125.4*	127.0*	128.2*	128.7*	130.5*	120.0*	124.9*	128.6*
Imports	102.3	103.3	104.0	105.5*	104.0*	101.5*	102.2*	102.6*	103.3*	104.6*	105.6*	102.3*	103.3*	104.0*
Government Purchases	274.3	278.4	279.3	1.8	−0.2	0.2	0.5	0.2	0.4	0.5	0.4	0.4	1.5	0.3
Federal	99.4	101.8	102.5	2.1	0.0	0.5	1.1	0.5	0.8	1.1	1.2	0.8	2.4	0.8
State and Local	174.9	176.6	176.8	1.6	−0.3	0.0	0.2	0.1	0.2	0.1	0.0	0.2	1.0	0.1

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

As stagflation retards sales, income and property tax receipts for state and local governments, tax-exempt bonds pour into credit markets. Credit standings of these governments deteriorate markedly, forcing the Federal Government to come to their rescue.

Consumers: Their purchasing power evaporates and consumers resort to debt even to meet necessities. Delinquency rates rise. Discretionary purchases depend on availability of credit and become highly cyclical. In addition, costs of operation and maintenance of automobiles, appliances and houses escalate rapidly. Manufacturers and builders have to be content with replacement demand only. A second income in a family becomes essential for many more households.

Businesses: A high inflation and low demand environment mean stiff competition, rising expenses and scant profits. The name of the game becomes "market share." Small and/or weak firms fall by the wayside. Accordingly, market concentration increases in most industries.

Surviving businesses attempt to maintain profits through expense controls and efficiency. Payrolls are held to a minimum and labor-saving devices like automated facilities are widely used. In the face of capital shortages, low demand, high inflation and unprecedented uncertainties, capital spending is generally limited to equipment with fast payback periods.

Energy: As an anti-inflation measure, strict price controls on energy are reimposed. Environmental concerns and accidents limit the development of coal and nuclear power. Our dependence on foreign oil increases. In the name of national security, energy rationing is introduced. Businesses and jobs suffer due to limited energy availability.

Government gets deeper into the development of alternative energy sources. As usual, government inefficiency and the bureaucracy become roadblocks to any meaningful progress in the endeavor.

Foreign Sector: Oil deficits mount. American-made products gradually lose competitive advantages here at home and abroad. Rising trade imbalances and the ranks of unemployed workers sway the Federal Government to install protectionist trade barriers. Our trading partners retaliate. The value of the dollar becomes volatile and unstable, with the result that the dollar can no longer function as the key reserve currency of the world. The overhang of unwanted dollars overseas further depresses the value of our currency. The Federal Government orders foreign exchange and capital flow controls. There are no winners, only losers.

Social Problems: Prices and taxes go up faster than income, shrinking buying power. More and more women in the family seek employment trying to make ends meet, but job opportunities are limited. In the meantime, a growing portion of the labor force ends up on government dole. The working middle income group resents the whole thing. The work ethic and productivity deteriorate.

Under this pessimistic scenario the mood of the nation becomes increasingly angry, cynical and helpless. Divorce rates go up and family units slowly disintegrate. Economic and social trends move in tandem.

Further Thoughts

These are difficult and frustrating times for the nation. With all the problems facing each of us today, it would be so easy to get depressed and to stop trying to reverse the trend.

However, a careful study of U.S. history tells us that the nation has gone through far worse economic, social and political crises before and has endured. Each time the country has come out in one piece, unscathed and stronger. If over two hundred years of history is any guide at all, history should repeat itself once again.

But, we have to be realistic. Inflation is a long-run problem and, once engrained, this disease is hard to control. It will take a long time because there are no "quick solutions." Like a patient's fever, the economic problems may get worse before getting better. The crucial question is, "Are we ready to bite the bullet?"

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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Spring 1980 Regional Economic Survey

May 8, 1980

Highlights

- **Economic conditions are expected to deteriorate throughout much of the region during the next six months suggesting the long awaited recession has finally arrived.**
- **A cost-price squeeze has depressed farm income throughout much of the region, with the notable exception of dairy and cow-calf areas. Extremely dry pasture conditions, however, are causing real concern for some cow-calf producers.**
- **Liquidity pressures have eased somewhat at agricultural banks which were most affected by last year's grain handlers strike. Yet, credit conditions generally remain tight as loan repayment rates have plunged.**
- **While sufficient funds are available for crop production expenses, very little credit is being made available for expansion of farm operations and purchases that can be postponed. Farm machinery and equipment sales are expected to be the hardest hit.**
- **Additional government loans may help ease liquidity pressures somewhat at agricultural banks. Many bankers, however, feel that more government credit is not the answer to current farm problems. Instead, farmers need higher prices so they can reduce their debts.**
- **Historically, this region has been less affected by national economic downturns than the national average. Due to depressed farm conditions, a repeat performance is less certain this time around. In most rural towns, farmers and businesses alike will suffer, but most are expected to survive.**
- **Because of its diversified economic structure and the large amount of commercial construction already underway, the Twin Cities will be less seriously affected than many other parts of the region. Oil and gas exploration in the Williston Basin will also help keep parts of North Dakota and Montana relatively strong.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Economic Outlook

Our eighth semi-annual survey of Upper Midwest bankers reveals the greatest amount of pessimism concerning the outlook for the regional economy since this survey began in 1976. Indications are that the long-awaited recession is underway.

This picture emerges from survey responses from nearly 700 bankers located in the Twin Cities, Minnesota's Iron Range, and agricultural communities in Iowa, Minnesota, Montana, Nebraska, North and South Dakota and western Wisconsin. The survey was conducted in April.

Twin Cities: Aside from reported weakness in auto sales, retail sales have held up fairly well in the Twin Cities. About 55 percent of the area bankers report retail sales are the same as a year ago, while 35 percent feel they are worse. Clothing sales have been relatively strong, particularly at both the high-quality and discount stores. However, sales are expected to falter.

High inventory carrying costs have made retailers quite cautious regarding inventory levels. However, they still may prove to be too high if sales should decline sharply.

Residential construction has already been hard hit as record-high mortgage rates have priced many potential home buyers out of the market. As a result, the decline in home-building could be at least as severe as the 1974-75 crunch.

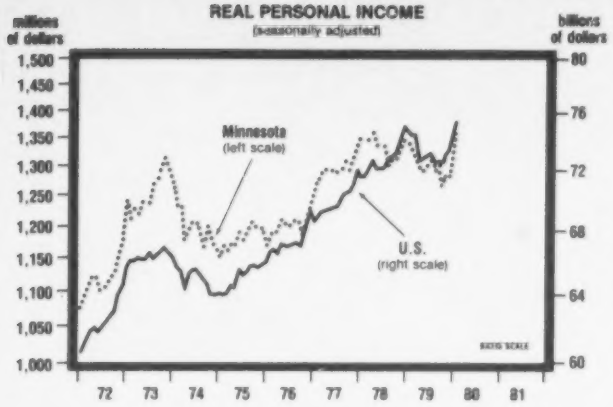
The weakness in the housing sector appears to be spreading. Layoffs have occurred in industries related to home construction, and Twin Cities bankers indicate that major household appliance sales are worse than a year ago.

Three-fourths of the Twin Cities bankers expect economic conditions to get worse during the next six months, while only eight percent expect conditions to improve. Accordingly, the confidence index for the Twin Cities fell to its lowest level since this survey began. Twin Cities bankers report an increasing amount of "fear psychology" among consumers. They believe that excessive concentration on bad economic news may well be a self-fulfilling prophecy.

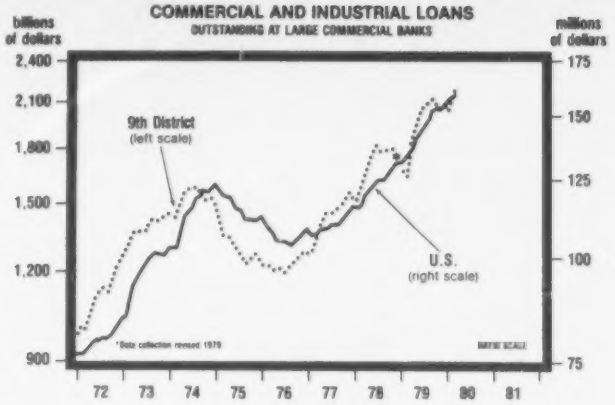
Concern is also expressed over the impact of high interest rates on small businesses in particular. Some Twin Cities bankers expect a serious shakeout of businesses as a result of increased bankruptcies.

REGIONAL ECONOMIC CONDITIONS

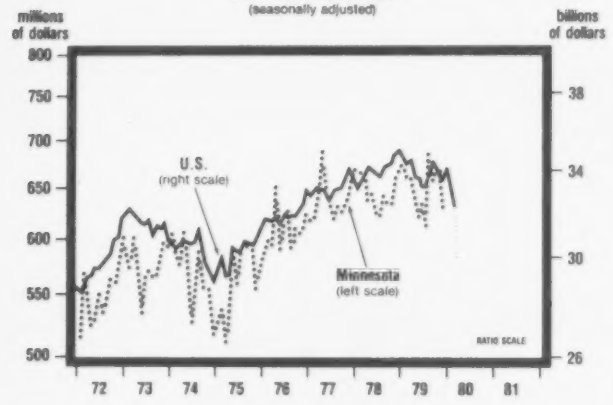
REAL PERSONAL INCOME
(seasonally adjusted)



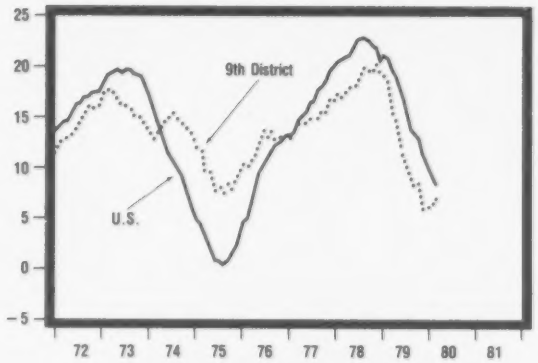
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



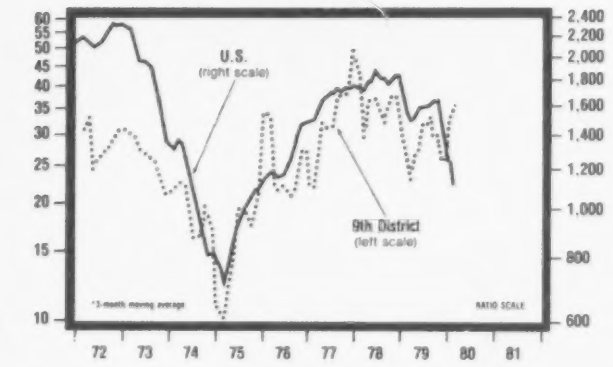
REAL RETAIL SALES
(seasonally adjusted)



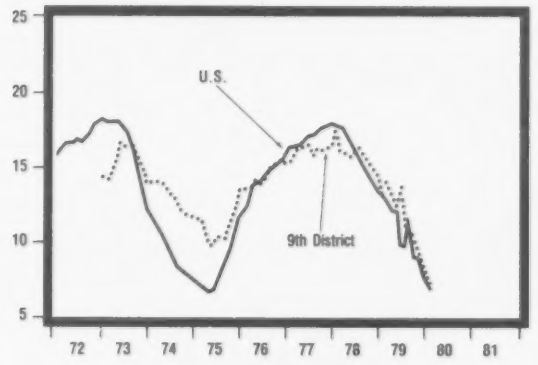
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



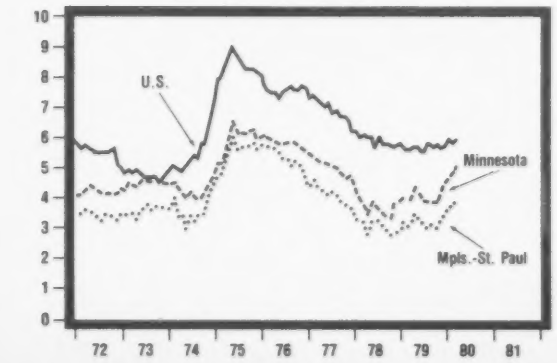
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



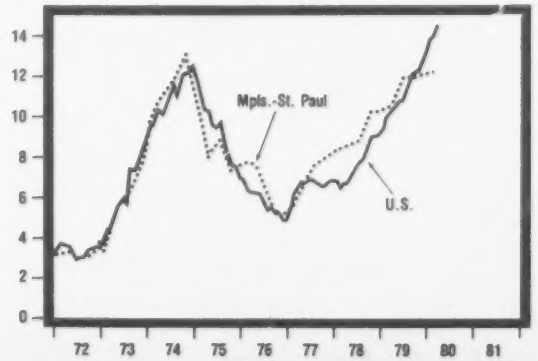
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



Even so, the recession is expected to be less severe in the Twin Cities than in some other parts of our region. The Twin Cities economy is expected to be buffered by a relatively strong electronics sector, the large amount of commercial construction currently underway and the large concentration of service sector jobs.

Iron Range: Current economic conditions appear to be somewhat weaker in the Iron Range region of Minnesota than in the Twin Cities. Three-fourths of the Iron Range bankers indicate that retail sales are worse than a year ago. Auto sales are depressed as is homebuilding. In addition, over 90 percent of the Iron Range bankers report that capital expenditures on plant and equipment are lower than a year ago, reflecting the completion of certain large construction projects.

About 55 percent of the Iron Range bankers expect economic conditions to get worse during the next six months, while almost 25 percent expect conditions to improve. The bankers quickly add that the economic outlook for northeastern Minnesota depends crucially on the outcome of contract negotiations which began this summer between the mining industry and the steel workers.

Farm Communities: Agricultural bankers' attitudes concerning the economy made a sharp shift from confidence to pessimism since last October's survey. With the notable exception of dairy and certain cow-calf areas, economic conditions are depressed in most farm communities.

Farmers are being squeezed by low crop and livestock prices and skyrocketing fuel, fertilizer, chemical and interest costs. Bankers in western South Dakota, eastern Montana and parts of North Dakota also expressed real concern over the serious shortage of moisture which their wheat and cow-calf producers are experiencing.

Over three-fourths of the agricultural bankers report that farm income is lower than a year ago. However, 85 percent of the bankers in western Wisconsin indicated that farm income is either higher or the same as a year ago. Similarly, over 60 percent of the bankers in western Montana said farm income was either the same or higher than last year. Bankers also report softening land prices in most areas in response to lower farm income.

REGIONAL ECONOMIC SURVEY SUMMARY TABLE
SPRING 1980
BUSINESS CONDITIONS*

(1) Is **farm income** higher or lower than it was a year ago?

	Higher	About the Same	Lower
Ag Banks	7%	16%	77%

(2) Are **retail sales** better or worse than they were a year ago?

	Better	About the Same	Worse
Ag Banks	2%	26%	72%
Twin City Banks	8%	56%	36%
Iron Range Banks	0%	25%	75%

(3) Are farmers (local businessmen) making more or less **capital expenditures** (such as buildings, machinery, and other farm and business equipment) than a year ago?

	More	About the Same	Less
Ag Banks	0%	4%	96%
Twin City Banks	4%	16%	80%
Iron Range Banks	0%	8%	92%

(4) Are **land prices** higher or lower than a year ago?

	Higher	About the Same	Lower
Ag Banks	17%	63%	20%

(5) Do you think the **overall economic condition** in your area will be better or worse six months from now?

	Better	About the Same	Worse
Ag Banks	9%	25%	66%
Twin City Banks	8%	18%	74%
Iron Range Banks	23%	23%	54%

CREDIT CONDITIONS

(6) Are your customers **repaying loans** at a faster or slower rate than they did a year ago?

	Faster	About the Same	Slower
Ag Banks	4%	31%	65%
Twin City Banks	14%	63%	23%
Iron Range Banks	8%	77%	15%

(7) In the past six months did your bank **deny loan requests** due to lack of funds?

	More Than Normal	No More Than Normal	Less Than Normal
Ag Banks	44%	53%	3%
Twin City Banks	39%	57%	4%
Iron Range Banks	46%	46%	8%

(8) Do you think your **loan demand** will be higher or lower six months from now?

	Higher	About the Same	Lower
Ag Banks	55%	35%	10%
Twin City Banks	26%	28%	46%
Iron Range Banks	8%	38%	54%

AGRICULTURAL CONDITIONS

(9) Excluding grain still under CCC loan, are farmers **holding more or less grain** than they did a year ago?

	More	Same	Less
Ag Banks	67%	27%	5%

(10) What affect have transportation problems had on movement of grain in your area?

	Slight	Moderate	Severe
Ag Banks	21%	38%	41%

(11) What changes do you expect in **beef cattle breeding herds** in your area in 1980?

	Increase	No Change	Decrease
Ag Banks	21%	66%	13%

(12) What changes do you expect in **hog breeding herds** in your area in 1980?

	Increase	No Change	Decrease
Ag Banks	9%	31%	60%

*Data show proportion of bankers falling in each of the categories higher, same, lower, etc.

Two-thirds of the agricultural bankers expect overall economic conditions to deteriorate during the next six months, less than 10 percent expect conditions to improve. The greatest amount of pessimism exists in Iowa and Nebraska where 75 to 80 percent of the bankers expect economic conditions to get worse during the next six months. Some agricultural bankers report that there is a serious lack of confidence in the government's ability to control inflation, put its own house in order and stabilize the economy.

Agricultural bankers report that depressed farm income and shattered confidence is already having a serious effect on their farm communities. Farm machinery and equipment sales are among the most seriously affected, although repair business is up significantly. Practically all agricultural bankers reported that farmers are making less capital expenditures for buildings, machinery and farm equipment.

In addition, over 70 percent of the bankers said that retail sales are worse than a year ago. In western Wisconsin, however, less than half of the bankers report weaker retail sales. The general feeling in the rural towns is that farmers and business alike will suffer from depressed farm income. Yet, with everyone working together, most will survive.

Credit Conditions

Twin Cities/Iron Range: In early April, the lending rate charged for working capital loans rose to an average of 18.2 percent at Twin Cities banks, up from 12.0 percent a year ago and 13.2 percent early last October. Starting from similar levels, interest rates charged by Iron Range banks rose to 18.7 percent. These higher rates reflect the rise in costs of purchased funds and the shift toward more costly deposits such as six-month-money-market certificates.

Credit availability also tightened since last fall. About 40 percent of the Twin Cities bankers denied loan applications due to lack of funds. Nearly 60 percent indicated they were less active than normal in seeking new loan accounts.

Even so, the average loan-to-deposit ratio at Twin Cities banks rose to 71.1 percent, up 2.2 percentage points from last fall. Slower deposit growth is at least partially responsible for the tighter liquidity position. Over 50 percent of the Twin Cities banks reported significant deposit losses to treasury issues and money market mutual funds.

The loan-to-deposit ratio at Iron Range banks averaged 70 percent this spring, down from 71 percent a year ago. Even so, the survey results suggest that credit conditions remain tight. Over 45 percent of the Iron Range bankers denied loan requests due to lack of funds and more than 55 percent were less active in seeking new customers.

As a result of high interest rates, credit controls and a weakening economy, both Twin Cities and Iron Range bankers expect loan demand to decline during the next six months, especially for consumer installment loans and mortgages. Commercial and industrial loan demand is also expected to soften, but not by as much as consumer loans. Bankers in both of these localities also indicate that customers are repaying loans somewhat faster than six months ago when repayment rates slipped to their lowest levels since the survey began.

Agricultural Banks: Rapid inflation and credit tightening by the Federal Reserve caused an unprecedented jump in interest rates charged by agricultural banks. Although still lagging the prime rate, the typical interest rate charged for farm operating loans jumped to 17.0 percent, compared to 10.0 percent a year ago and 11.4 percent last fall.

Prior to late 1978, interest rates charged by most agricultural banks were not set up to follow money market rates. However, increased costs of purchased funds and higher rates paid on deposits including a big shift to money market certificates has changed all of this.

Just 18 months ago, six-month-money-market certificates accounted for less than five percent of the time deposits at practically all agricultural banks. Today they account for at least 30 percent of the time deposits at over half of the agricultural banks. As a result, more and more farm loans are either being set up on a variable rate basis or, alternatively, the maturities of fixed rate loans are being shortened.

The loan-to-deposit ratio at agricultural banks averaged 67.8 percent, up 2.2 percentage points from a year ago but down 1.1 points from the record level reached last fall. The most notable easing since last fall occurred at banks in the Red River Valley, reflecting the settlement of last year's grain-handlers strike in Duluth.

Despite the decline in the average loan-to-deposit ratio from last October's level, agricultural credit conditions generally remained tight. Outside the Red River Valley, the loan-to-deposit ratio at agricultural banks in Minnesota eased very little since last fall. And, the ratio actually increased in Iowa and Nebraska.

Moreover, loan repayment rates at agricultural banks fell to their lowest level since the survey began. Bankers note that farmers are reluctant to sell their 1979 crops because prices are considered too low.

Further evidence of tight credit conditions is obtained from the fact that nearly 45 percent of the agricultural bankers turned down loan requests due to lack of funds and 70 percent were less active than normal in seeking new loan accounts.

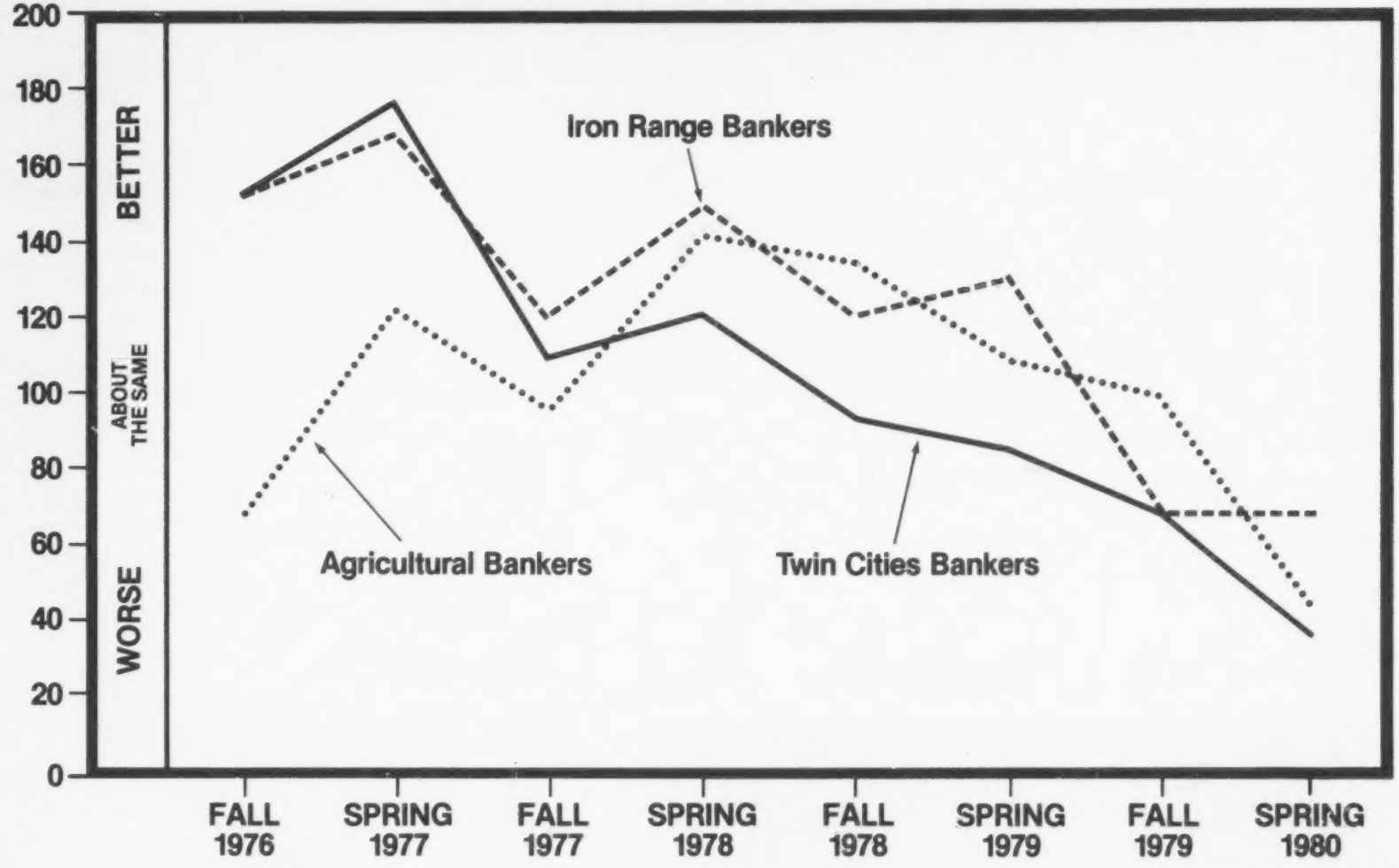
In order to meet the strong loan demand for crop operating expenses, very little credit is being made available for purchases that can be postponed. Loans for machinery, equipment and livestock buildings are expected to decline the most. Agricultural bankers also expect a reduction in loans for grain storage facilities, suggesting that farmers may have less flexibility in marketing grain this fall. In addition, total nonagricultural loan volume is expected to be relatively flat.

Despite an expected slowdown in the overall growth of loans, agricultural bankers feel loan demand will outdistance the growth of deposits. Accordingly, liquidity is expected to remain tight at agricultural banks.

However, increased government loans are likely to ease pressures on rural credit markets. The Economic Emergency loan program of the Farmers Home Administration has been extended through September 1981 and the ceiling on the agency's outstanding loans was increased by $2 billion.

UPPER MIDWEST CONFIDENCE INDEX

Percent of bankers expecting economic conditions to improve
minus percent expecting conditions to deteriorate during the next six months plus 100.



Farmers have also been authorized to enter their 1979 corn crop into the three-year grain reserve program even though they did not comply with acreage set-aside requirements last year. Storage payments and CCC loans are provided to farmers that enter the reserve. Furthermore, since there are no set-aside requirements for the 1980 feed grain and wheat programs, all producers of these crops this year will be eligible for CCC loans, the grain reserve and other farm program benefits.

A number of bankers commented that more credit through government agencies is not the answer to our current farm problems. Instead, farmers need better prices so that they can reduce their debts.

Agricultural Conditions

Grain Storage: Two-thirds of the agricultural bankers report that farmers are holding more grain than a year ago. Farmers are faced with the dilemma of either selling grain at prices they consider too low or paying high interest carrying costs.

In part, bankers blame the large holdings of grain on the embargo, last year's grain-handlers strike and transportation problems. Fifty percent or more of the agricultural bankers in the Minnesota Red River Valley, North Dakota, eastern South Dakota and eastern Montana indicated that transportation problems have had a severe impact on movement of grain. In some areas, availability of transportation was not currently considered to be a serious problem, simply because farmers are not selling grain.

Bankers complained about loss of rail service and unusually large local differences in grain prices depending upon availability of suitable rail service. In addition, the railroad rate structure was considered inequitable in certain parts of the region.

Crop Acreage: In contrast to the USDA's April 1 planting intentions report, bankers expect farmers will boost soybean acreage and decrease corn acreage even though soybean prices are low relative to corn. Currently, the soybean-corn price ratio is about 2.2 to one, a ratio which normally would favor a switch to corn. However, given the higher fertilizer requirements for corn combined with high interest rates, farmers may tend to plant more soybeans in our region.

Farmers are also expected to increase wheat acreage sharply while cutting back sunflower acreage considerably. Overall crop acreage is expected to increase this year due to the elimination of set-aside requirements for wheat and feed grains. Credit availability is not expected to hamper the planting of crops. Thus, we have the potential for another large crop if weather conditions are favorable.

Livestock: Prices are being depressed by both large supplies of pork and poultry and weak consumer demand. Since pork prices have fallen substantially below production costs, agricultural bankers expect hog breeding herds to decline this year. They also expect depressed beef prices to slow the rebuilding of beef cattle herds. However, bankers expect both beef and hog prices to strengthen later this year as large supplies of hogs begin to recede.

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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Does Countercyclical Economic Policy Matter?

June 24, 1980

Highlights

- **The rational expectations approach to economic theory has gained many proponents and critics since its initial formulation in the early 1960s. The rational expectationists' view on the effectiveness, let alone the desirability, of countercyclical monetary and fiscal policy actions has profound implications for policymakers. In order to promote further understanding and discussion of the concept and its implications, this article briefly describes the rational expectations approach as well as criticisms of it.**
- **The rational expectations school argues that if people, including policymakers, behave in a consistent and predictable manner, then the public will know what policy actions will be taken in any given set of economic circumstances. Thus, rational expectationists conclude that changes in monetary or fiscal policy designed to "fine-tune" the economy will be ineffective at best and counterproductive at worst.**
- **Although not suitable for countercyclical purposes, fiscal and monetary policies remain important tools for causing long-term structural changes in the economy. Stable and credible policies in effect over the long run can direct rational behavior toward desirable goals.**
- **Critics of the rational expectations approach contend that relatively few segments of society have sufficient understanding of the relevant economic forces to behave rationally in a consistent manner. Moreover, many institutional rigidities such as long-term contracts exist which will prevent rapid change in economic behavior despite changes in expectations.**
- **Regardless of the final outcome of the debate, rational expectations theory has one very important lesson: a policymaker attempting to determine the likely outcome of a new policy must consider how the public will perceive it. Thus, the credibility and intentions of government officials take on new significance.**

Dr. Sung Won Son
Senior Vice President and
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Rational Expectations

When economists get together nowadays, an issue likely to generate the hottest argument is the question of the "rational expectations" view of the world. The issue at stake is a profound one: does countercyclical economic policy matter? The basic question is not merely whether one policy is better than another, but whether any countercyclical economic policy is effective. This is no longer an ivory tower debate. It has found its way into the popular financial press where strong opposing opinions are found.

Activist Policies

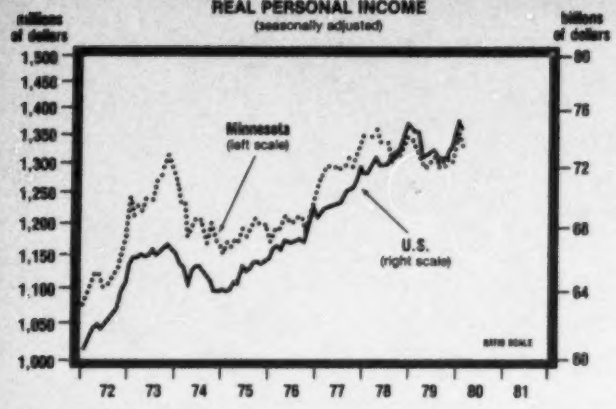
Economic policy in the United States since the New Deal Era of the thirties has been an activist policy — a policy in which the government has continually intervened in the economy to moderate the business cycle and encourage economic growth. This policy was born of the necessities of the Great Depression. It found its theoretical justification in the work of John Maynard Keynes.

The content of this policy has been the use of fiscal and monetary policy to offset instability generated in the private sector of the economy. It has often meant that in a recession the government increases spending or reduces taxes to increase aggregate expenditures. In addition, the government may increase the money supply to reduce interest rates so that business investment will be stimulated.

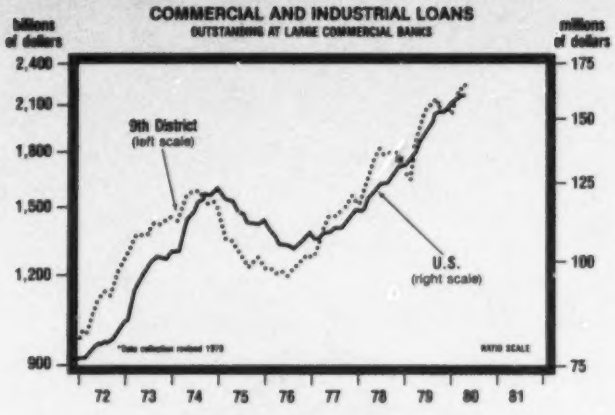
In contrast to activist policies, one can distinguish a series of non-discretionary policies which go under the name of "automatic stabilizers." These policies were introduced during roughly the same period that activist policies became popular. Policies, such as unemployment compensation and progressive income taxes, partially offset the declines in income that occur in recession, and reduce the increases in income

REGIONAL ECONOMIC CONDITIONS

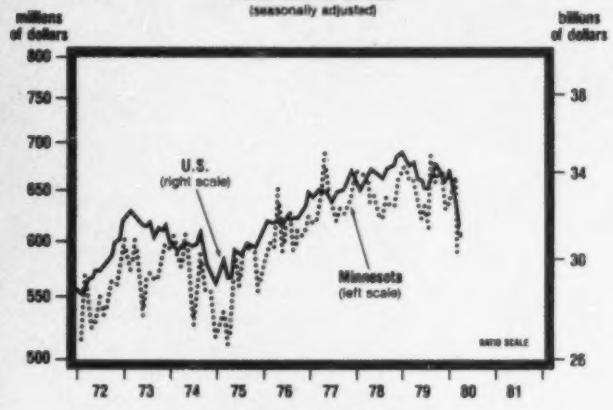
REAL PERSONAL INCOME
(seasonally adjusted)



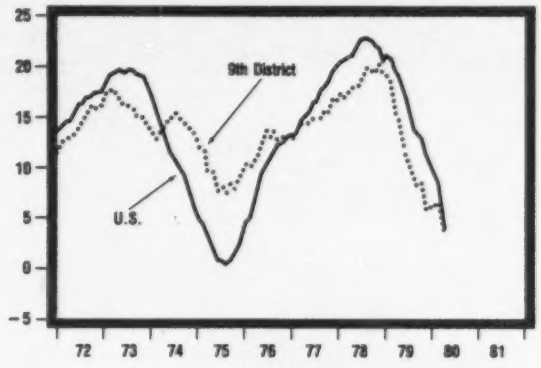
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



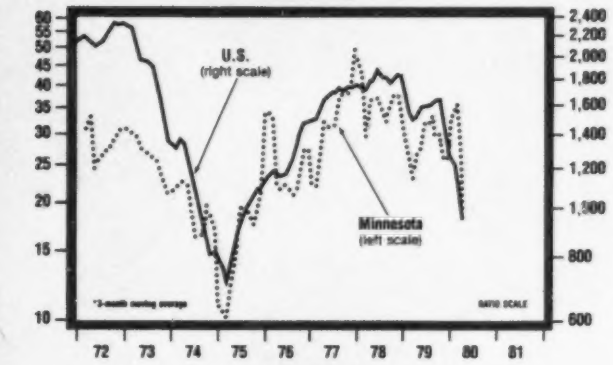
REAL RETAIL SALES
(seasonally adjusted)



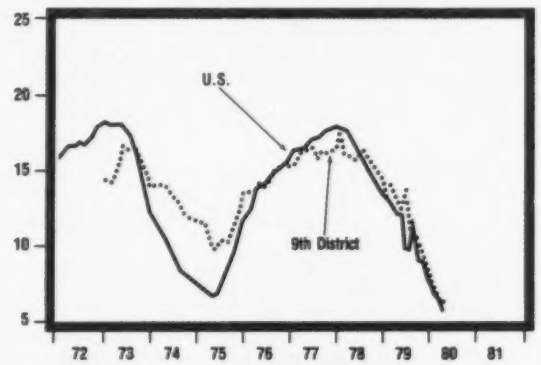
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



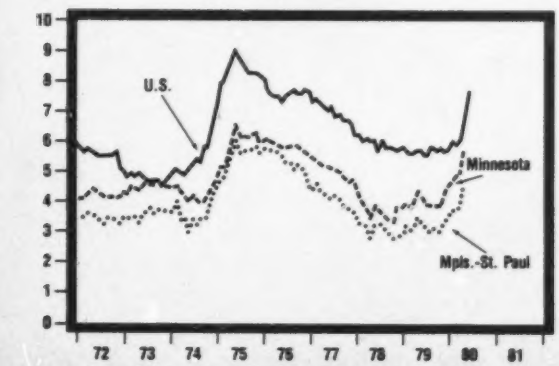
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



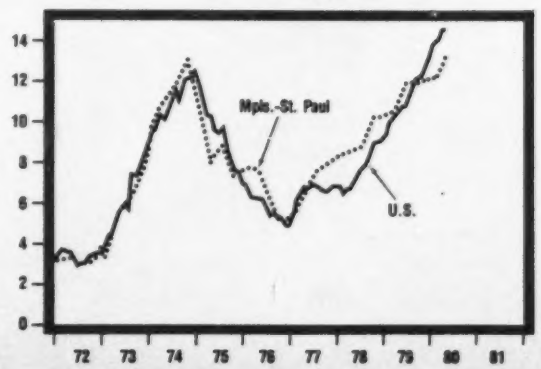
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



that would occur in times of expansion without any discretionary interference of the fiscal or monetary authorities. These two types of policies were both the result of the general attitude that prevailed in the thirties and in the postwar period. This attitude was a desire for the government to do something to deal with current economic problems. The two policies, however, represent two very different approaches to dealing with the same problem.

J.M. Keynes and his critic, Milton Friedman, both agreed that monetary and fiscal policies mattered, though with quite different opinions about their relative salutary influence on the economy. Keynes argued that fiscal policy was the more important of the two major policy instruments. Friedman, on the other hand, argued that fiscal policy was relatively ineffectual in stabilizing economic activity, and that monetary policy had far more reaching consequences for the economy.

Even so, Friedman argued against the use of discretionary monetary policy and for its replacement with a monetary rule of stable growth of the money supply. He felt discretionary policy would affect the economy in the wrong way because of the long lag between the implementation of monetary policies and their effect on the economy. Also, he felt that discretionary policy was too variable to permit a consistently successful policy to be followed. Under these circumstances, Friedman argued that discretionary monetary policy was like playing Russian roulette with the economy. It could never be known whether a particular policy action would have a desired or undesired effect on the economy; a stable policy was more likely to be successful. If money supply growth is fixed at a stable rate of growth, it will slow down the economy when rapid expansion takes place and it will stimulate the economy when the rate of growth slows down. In short, Friedman's monetary rule acts as an automatic stabilizer.

Underlying the Friedman view, and in contrast to that of Keynes, is the belief that the economy is inherently stable and will always return to its long-run growth rate established by real factors such as technology, growth of the labor force and the long-run rate of saving.

Friedman's criticism of activist policy amounted to saying that it is a difficult, but not necessarily an impossible, task to conduct discretionary policy in a manner that will achieve positive results. The criticism that was to be launched by the rational expectationists was much more sweeping: they were to deny the possibility of any successful activist policy.

Rational Expectations

The rational expectations school (RES) argues that if people, including policymakers, behave in a rational (i.e., consistent) manner, then the public, when it recognizes that a particular economic situation is developing, will know that policymakers will take certain policy actions. The public takes these policy actions into account in formulating its economic plans so that when the policy action is actually taken, it will have no effect whatsoever on their behavior.

The strongest assumption made by the rational expectations proponents is that people's expectations about the effect of policy on real factors, such as prices or wages, are not *systematically* incorrect, even in the short run. This line of thought can be applied to the case of the formation of price expectations. Because firms' profits and households' real wages depend, in part, on realized prices, people have a strong incentive to form their expectations as accurately as possible about future prices. They will do this by taking into account all the information available to them, including the available information about the probable course of monetary and fiscal policy. If expectations are rational in this sense, then systematic and therefore predictable activist policies can have no predictable real effects, since they already have been taken into account by individuals in their economic decisions.

Let us apply this to monetary policy. If the Federal Reserve System announces that it will increase the money supply over the next few months, and if everyone believes this is so, and the Fed actually increases the money stock as it has promised, then in an economy where expectations are formed rationally, everyone will react to this information by increasing their price and wage expectations to take account of the change in Federal Reserve policy. Workers will raise their wage demands to take account of the expected change in the rate of inflation; producers will take account of the expected higher wage demands in setting their future prices and production demands; lenders will take account of the higher expected rate of inflation in setting their interest rates; in short, everyone who might possibly be affected by a change in prices will have adjusted their individual economic plans to the expected rise in prices.

If everyone forecasts correctly the wage and price consequences of the Federal Reserve's actions, the effect of the increase in the money supply will be to increase prices, causing inflation, without any change in the real wage, expected real profits, employment or output. The result would be similar to a case where the Federal Reserve Board tells everyone to add an extra zero to all quantities denominated in dollars. This will increase prices and the nominal money supply ten times, but this change will be transparent and everyone will go on behaving

as before. Only if people are "tricked" into believing they are richer or poorer, will this change in the money supply and prices have any real effects.

Furthermore, it is not necessary that everyone's revision of expectations induced by an anticipated policy change be correct, although on the *average* it is expected they will be. Workers may, by chance, underestimate future inflation and therefore underestimate the change in real wages that their wage bargains will yield. Similarly, employers may initially interpret the rise in prices as the result of increased demand for their product and increase their work force. Expecting higher real wages, workers may increase their offer of labor services. These actions will result in a rise in output and employment.

Employment and output will continue to rise until the difference between expected and actual rates of inflation are eliminated. Eventually, as prices rise, workers will increase their wage demands to compensate for the effect of the inflation, producers' costs will rise, and their profits will fall resulting in a cutback in output and employment.

In the rational expectations view, then, it is only when the economic actors make errors in their expectations that real consequences flow for the economy. However, the RES is quick to point out that these errors in expectations may be positive or negative so that the direction of the outcome of any particular policy cannot be known ahead of time. Activist policy therefore depends on two assumptions according to the RES: uncertainty about the consequences of future policy changes, and slow rates of adjustment of actual wages and prices to expected changes in wages and prices.

Expectations, of course, play an important role even in traditional economic analysis. The idea that individual behavior depends on anticipated events is not a monopoly of the RES. Rather, the unique insight of the RES is that anticipated events, including policy actions, cause people acting in their own interest to change their behavior in such a manner as to render the final impact of economic policy unpredictable.

Applied to the control of inflation, the rational expectationist argues that if the Federal Reserve announces a sharp decline in the rate of growth of the money supply, and the public really believes this, then inflation will deaccelerate immediately, and it will achieve this costlessly. Furthermore, unless the economic authorities are capable of instituting economic policies in such a manner as to always surprise people, the best way in which to exploit the rationality of expectations is to provide a regime of predictable policies. Hence, the RES prefers a monetary growth rule and other nondiscretionary policy prescriptions to activist policies attempting to fine-tune the economy.

The rational expectations school is sometimes interpreted to imply that any governmental economic policy is ineffective. This is incorrect. They say that only a certain type of government policy is ineffectual, namely one triggered by feedback from the current state of the economy. For example, they will argue that an investment tax credit, introduced during periods of weak economic activity to increase aggregate demand, will not be effective. Rather, it will already be taken into account in the investment plans of businesses. However, an investment tax credit introduced with the expectation that it will be permanent could alter the rate of business investment permanently, and affect the rate of growth of the economy. In less formal terms, the RES is arguing for economic policies that affect the structure of the economic environment and the long-run values of real economic variables.

Criticism of Rational Expectations

At this point in the discussion, you might have some reservations about the capacity the RES assigns to the individual. While it is flattering to say that individuals are rational and cannot be "fooled", at least systematically, it does seem to stretch the capacity of informed rational individuals to absorb, process and act upon all the relevant available information.

RES requires the individual to know more about the economy than seems realistically possible, and to have at least as much information as policymakers have. Even large economic organizations have difficulty gathering and processing all the information relevant to a particular economic decision. Furthermore, there is no guarantee that rational individuals will form expectations distributed about the same average value. As has been pointed out by Richard Muth, the father of rational expectations, the formation of an economic expectation is similar to making an economic forecast. Since economists are not agreed as to which models will yield the "best" forecast, is it reasonable to assume that there will be any greater unanimity among the people at large?

Furthermore, rational expectations assumes that after the relevant information has been gathered and processed and expectations have been formed, decisions based on these expectations can be acted upon immediately and without cost. This, of course, is not the case. It is not possible to alter productive processes immediately, nor is it possible to renegotiate all contracts concerning prices and wages, simply because expectations have changed. As long as economic agents cannot adjust rapidly and costlessly to changed expectations, the results are similar to the case where they are "surprised". During this interim period, when they try to adjust

to their expectation, there is scope for an activist policy to have real effects.

Most of the discussion of rational expectations has focused on aggregate economic activity, employment, and demand. An equally important issue is the *composition* of output. Here, even the RES admits activist policies may affect the commodity composition of output and the distribution of income. Augmenting accelerated depreciation allowances, for example, will affect the composition of savings and investment in the short-run and the rate of growth in the long-run.

The Bottom Line

A good deal of economic knowledge consists of putting old wine into new bottles. Rational expectations, by making a group of extreme assumptions, has forcefully called to our attention some fundamental economic truths.

The basic assumption that expectations are rational and that individuals, acting in their own interest, try to anticipate the impact of expected policy changes on wages, prices, and patterns of supply and demand, is common sense. The argument that they do this exhausting all available information and share the same basic concept of the interrelationship of the economic variables is clearly an overstatement made in the interests of academic rigor but at variance with the current state of the world.

The presence of information costs and obstacles to the immediate and costless adjustment of prices, production, financial variables and wages to conform to individual's expectations of the future implies that the rational expectations conclusion that an activist policy will have *no* effect on the economy is invalid. The RES does, however, have a valid point that individuals attempting to act in their own interest based on their expectations of future policy decisions will tend to *partially* offset the efficiency of these policies.

A curiosity of the RES is that only if their view is false, can one argue that activist policymakers in the past have had a destabilizing influence on the economy in the macroeconomic realm. If the RES position were true, activist policies would have had no real effect on the economy. It is because of this last consideration that leading exponents of imposing a monetary growth rule have been slow to embrace a rational expectation view of the world.

The emerging view is that activist policies have a role to play in achieving short-run stabilization, but work less efficiently and predictably than was customarily believed before, because the behavior of intelligent human beings is not invariant but takes into account the policies being followed by the economic authorities. Moreover, long-run policies will be more effective the more stable and *credible* they are. Applied to today's problem of inflation, the effectiveness of the Federal Reserve's actions will depend in large measure on whether they can convince the public of their ability to stick to their policy of a slower rate of monetary growth.

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northwest economic indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

National Outlook

July 17, 1980

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Highlights

- **The current recession will be the second-worst tumble during the post-war period. The unemployment rate will approach ten percent, well above the previous peak of nine percent.**
- **Even though a flood of economic bad news will continue, the steepest decline is behind us. Economic weakness will shift from autos and housing to inventory and capital spending.**
- **The economic rebound, which should commence sometime during the first half of next year, will be slow and gradual. The combination of weak purchasing power, the need to increase the savings rate and depressed consumer confidence will make a recovery in consumer spending long and difficult.**
- **Fuel and mortgage rates have been over-stating the true inflation picture. In coming months, the same factors will tend to understate price increases. The underlying core rate of inflation will continue to advance at a double digit rate.**
- **Slack loan demand and sluggish monetary growth will lead to downward pressure on interest rates well into 1981.**

Entering a cold lake, a swimmer can either ease in a little at a time or simply jump right in. Similarly, a business cycle downturn can be entered gradually or with a steep, rapid fall. In each case, the method of entry has no relationship to the final comfort level associated with the changed environment.

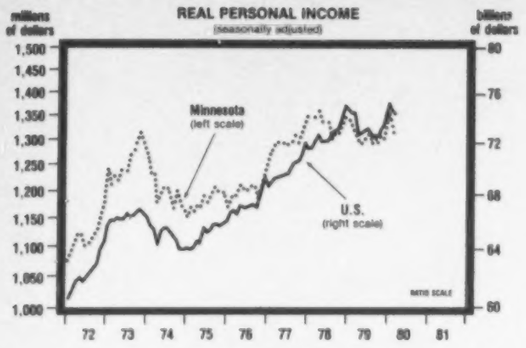
The U.S. economy is now very much like the swimmer who has jumped into icy water and has not yet come up for the first breath of air. The pain is acute and the question exists as to how long the pain will exist. The sharp deterioriation in economic activity witnessed throughout the second quarter of this year has indeed proved a sobering experience. The problem now is one of defining the probable shape of the current phase of the business downturn.

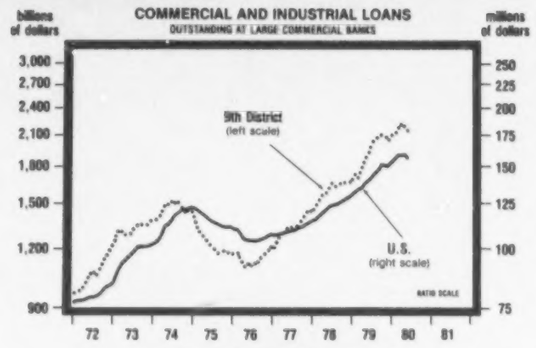
Business and the Consumer

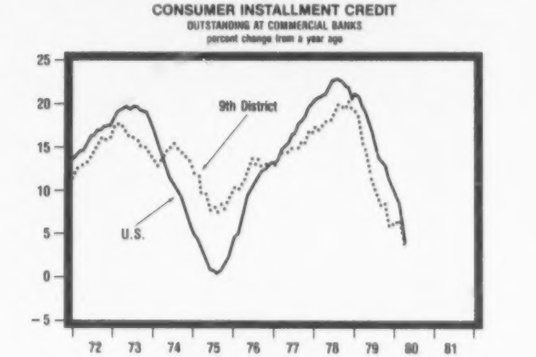
Spending, which determines the level of economic activity, is conducted by several broad economic sectors. Consumers, businesses, governments and foreigners all represent different spending groups, and changes in spending by one or more of these groups can affect the level of economic activity. The question is: which sector has contributed most to the current downturn?

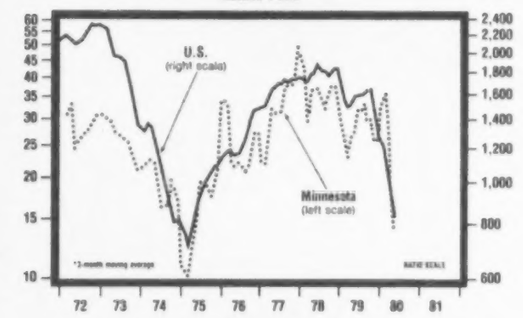
Business spending was a major villain in the 1974-75 recession. Due to rapid rises in the prices of many raw materials in the period immediately preceding that recession, businesses, exhibiting the same form of inflationary psychology recently attributed to consumers, went on a buying spree. The heavy accumulation of inventories by businesses in 1973 and early 1974 greatly reinforced the severity of that recession. When consumer spending began to slow down in 1974, businesses were forced to cut back spending not only because of softening sales activity, but also because of the need to get rid of the excessive inventories which they had accumulated earlier. This inventory decumulation reached nearly $45 billion peak to trough in the last recession, compared to the approximate $10 billion reduction in inventories which characterized earlier postwar recessions.

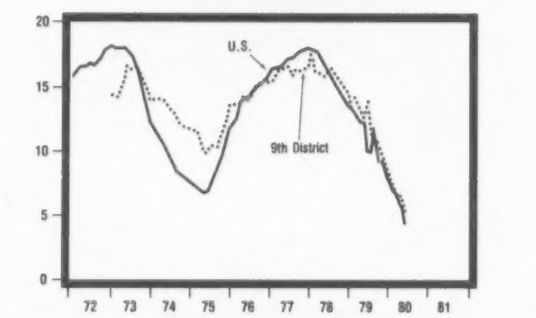
REGIONAL ECONOMIC CONDITIONS

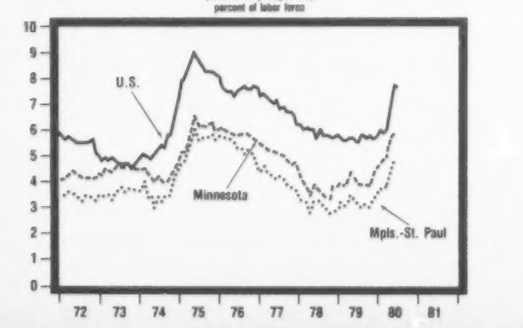


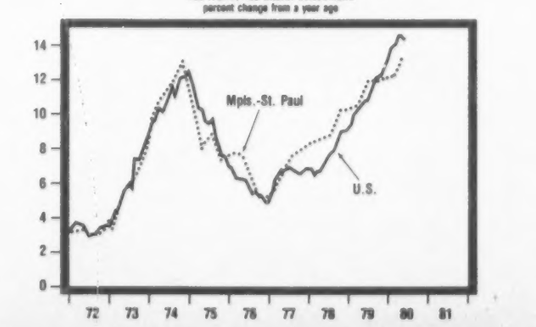












The bad experience of 1974-75 apparently taught businesses a lesson. Throughout the expansionary period since the last recession and even into the early months of the current recession, businesses have been very careful in their attempts to maintain inventory levels. Consequently, despite the fact that rapidly falling final sales are now leading to some accumulation of unwanted inventories, the size of the real inventory correction in this recession is likely to be less severe than in 1974-75.

This recession is a consumer-induced recession. The importance of consumers and changes in their spending behavior should never be underestimated, since consumer spending accounts for about 65% of total expenditures in the United States.

Faced throughout last year with an inflationary situation that caused substantial deterioration in purchasing power, consumers dipped into savings, took equity out of their houses, and added installment debt at a record pace. Much of this was done as an inflation hedge.

There is, of course, a limit to consumers' ability to spend beyond their means. And this limit was approached in the early months of this year. In addition, the imposition of selective controls on consumer credit extensions by the Federal Reserve in March reinforced the consumer retrenchment pattern which had already begun.

Retail sales, which began to slide in February, have continued to decline up to the present. The particularly distressed conditions in the automobile and residential construction industries certainly need no further explanation other than to say that the earlier problems of escalating fuel prices, fears of gas shortages and a mortgage crunch have now been followed by a cautious recessionary psychology on the part of the consumer.

To summarize, consumers ended their spending spree abruptly in the first quarter and triggered what is now considered a sharp, severe recession. The corollary to this is that the consumer must now play the major role in any economic recovery. The resumption of consumer spending patterns conducive to both economic growth and relative price stability will not be easy to achieve, however, and will not occur simply because the consumer has been invited to use credit cards again.

Inflation and Purchasing Power

Contrary to government claims, the corner has not been turned on inflation. The basic, core pressures on inflation that existed earlier in the year remain today.

Temporary respite is presently being experienced in the rate of increase in both the producer price index and the consumer price index. But, just as sharply rising oil prices and mortgage rates overstated the CPI earlier this year, a slower rate of oil price increases and the substantial absolute drop in interest rates in the past three months will cause the CPI to understate the extent of inflationary pressures.

Lurking in the background is the sharp rise in production costs this year. Strains on productivity from both structural and cyclical causes are being accompanied by labor compensation increases at or above the 9.5% ceiling recommended by the wage and price guidelines. Together, these forces are effectively placing an approximate 10% floor on the core rate of inflation.

Consequently, these core inflationary pressures will continue to make substantial gains in purchasing power difficult to attain until well into 1981. Moreover, added to this situation is the need for consumers to reduce debt. Higher savings rates mean that the percentage of current income devoted to consumption expenditures will also be relatively low in the months ahead.

All is not gloom and doom, however. Consumers have already begun to rebuild liquidity. Labor productivity will improve as declines in employment begin to outpace declines in output, a normal cyclical phenomenon. As the recession stretches on, workers who have not lost their jobs will begin to feel more financially secure and will become more willing to spend and take on additional debt. Inventory adjustments will be completed and businesses will begin to increase their orders leading to first a slowdown and then a reversal in the pattern of the unemployment rate. Moreover, long before these improvements become evident, the Federal Government will be applying stimulative measures.

The Outlook

The combination of a recession and a presidential election is likely to prove to be too inviting a situation for Congress and the Administration to resist. Despite the inflationary concerns described above, a tax cut proposal at the very least can be expected well in advance of the elections in November. Whether such a cut, which if history is any judge would be strongly oriented toward the consumer, would take effect later this year or at the beginning of 1980 is not particularly important. The knowledge on the part of the voting public that it is coming would serve political aims while that same knowledge would also lead to some anticipatory spending by consumers.

A highly visible withholding tax decrease can be expected to prevail over a rollback in social security rate and base increases scheduled to take effect next January . Intuitively, a tax cut should be politically preferable to the postponement of a tax increase. There is no doubt that the Federal budget will not be balanced in fiscal 1981. The only question now is how large that deficit will be, with a very substantial deficit being all but certain.

On the monetary and credit side, recent sharp declines in interest rates should not be interpreted as expansionary monetary policy. The Federal Reserve is maintaining its emphasis on keeping money supply growth within a target range and allowing market forces to determine interest rate movements. Despite election year pressures, the Fed is expected to be successful in continuing this policy stance.

The decline in long-term rates combined with the lagging decline in the prime rate compared to other money market rates has shifted corporate borrowing activity sharply into the capital and commercial paper markets in recent months. The decline

ECONOMIC OUTLOOK
July 1980

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
				1980E				1981E						
	1979	1980E	1981E	I	IIE	IIIE	IVE	IE	IIE	IIIE	IVE	1979	1980E	1981E
Consumer Price Index (1967 = 100)	217.6	246.7	267.3	16.9	14.0	8.4	7.8	7.4	8.2	8.2	9.6	11.3	13.4	8.4
Food	234.9	252.3	278.3	6.0	5.0	9.0	12.1	11.2	10.5	10.0	9.0	10.9	7.4	10.3
Nonfood Commodities	195.0	222.9	241.5	20.5	12.2	8.6	7.7	7.2	8.6	8.0	10.0	11.7	14.3	8.3
Services	234.4	268.5	288.8	18.6	17.2	7.9	6.3	6.0	7.0	7.6	9.5	11.0	14.6	7.6
Producer Price Index, Finished Goods (1967 = 100)	216.1	243.8	270.2	17.0	9.5	9.5	11.0	11.2	11.2	11.0	11.1	11.1	12.8	10.8
Compensation Per Manhour, Nonfarm Private (1967 = 100)	247.9	271.2	298.6	10.2	9.1	9.4	10.0	11.0	10.5	9.5	9.0	8.9	9.4	10.1
Labor Productivity, Nonfarm Private (1967 = 100)	115.7	113.3	112.4	– 1.7	– 5.0	– 3.0	– 1.0	– 1.0	0.4	1.0	2.0	– 1.1	– 2.1	– 0.8
Unit Labor Costs, Nonfarm Private (1967 = 100)	214.3	238.9	264.8	11.9	14.1	12.4	11.0	12.0	10.1	8.5	7.0	10.2	11.5	10.8
Corporate Profits After Taxes, bil. $	144.0	129.2	112.9	33.8	– 50.9	– 40.0	– 20.2	– 12.6	5.0	25.0	40.0	18.5	– 10.3	– 12.6
Disposable Personal Income, bil. $ (1)	1624.2	1758.9	1891.9	13.5	2.0	4.0	6.0	6.0	10.0	12.0	15.0	11.4	8.3	7.6
Real Disposable Personal Income, bil. $ (2)	746.4	713.0	707.8	– 2.9	– 10.5	– 4.1	– 1.6	– 1.4	1.8	3.3	4.9	0.1	– 4.5	– 0.8
New Passenger Car Sales (millions of units)	10.7	8.6	8.6	10.7*	8.0*	8.0*	7.8*	8.3*	8.7*	9.0*	8.5*	10.7*	8.6*	8.6*
New Private Housing Starts (millions of units)	1.7	1.0	1.3	1.3*	0.9*	0.9*	1.0*	1.1*	1.2*	1.4*	1.5*	1.7*	1.0*	1.3*
Unemployment Rate, %	5.8	7.6	9.1	6.1*	7.5*	8.0*	8.9*	9.5*	9.2*	9.0*	8.7*	5.8*	7.6*	9.1*
Federal Government Deficit, bil. $	11.4	47.9	61.3	22.9*	38.5*	60.0*	70.0*	80.0*	70.0*	50.0*	45.0*	11.4*	47.9*	61.3*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

ECONOMIC OUTLOOK (Without Inflation)

July 1980

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change		
	1979	1980E	1981E	1980E I	1980E IIE	1980E IIIE	1980E IVE	1981E IE	1981E IIE	1981E IIIE	1981E IVE	1979	1980E	1981E
Gross National Product	1431.6	1405.9	1404.2	1.2	-9.6	-5.9	-1.2	-0.2	4.6	4.1	3.7	2.3	-1.8	-0.1
Consumer Expenditures	924.5	912.9	917.9	0.5	-10.9	-3.4	0.6	2.0	2.6	3.3	3.7	2.6	-1.3	0.6
Durables	147.1	127.1	123.8	-3.4	-48.0	-9.8	-3.6	3.1	6.2	10.5	10.3	0.3	-13.6	-2.6
Nondurables	349.1	349.3	351.1	-1.1	-5.2	-3.5	1.1	1.6	1.8	2.0	2.1	1.7	0.0	0.5
Services	428.3	436.5	443.0	3.2	0.0	-1.5	1.3	2.0	2.2	2.5	3.2	4.3	1.9	1.5
Investment	215.1	186.5	173.6	-8.3	-18.9	-26.7	-14.7	-19.7	30.9	8.2	11.0	0.4	-13.3	-6.9
Fixed Residential (1)	56.6	41.9	37.3	-26.2	-50.0	-40.0	-35.8	-5.0	22.1	35.2	40.8	-5.8	-26.0	-10.9
Fixed Nonresidential (2)	148.8	146.8	135.7	1.9	-9.3	-6.3	-5.3	-15.1	-5.0	-3.0	0.5	6.2	-1.4	-7.5
Structures	48.1	48.4	44.3	1.6	-13.5	-7.0	-4.8	-15.2	-6.7	-3.4	-2.1	9.6	0.5	-8.4
Producers Durable Equipment	100.7	98.4	91.4	2.0	-7.2	-6.0	-5.5	-15.0	-4.1	-2.8	1.8	4.6	-2.2	-7.1
Change in Inventories	9.7	-2.2	0.6	0.3*	1.8*	-5.0*	-6.0*	-9.0*	2.3*	4.0*	5.1*	9.7*	-2.2*	0.6*
Net Exports (3)	17.6	27.7	32.2	25.0*	27.0*	28.7*	30.0*	33.0*	31.0*	33.0*	31.8*	17.6*	27.7*	32.2*
Exports	119.9	131.0	135.3	131.7*	131.0*	130.2*	131.0*	134.0*	134.0*	137.0*	136.1*	119.9*	131.0*	135.3*
Imports	102.3	103.3	103.1	106.7*	104.0*	101.5*	101.0*	101.0*	103.0*	104.0*	104.3*	102.3*	103.3*	103.1*
Government Purchases	274.3	278.8	280.4	4.2	-1.5	-1.1	0.3	1.6	0.6	1.4	1.2	0.4	1.6	0.6
Federal	99.4	103.7	105.2	13.2	-4.0	-0.5	4.2	1.0	2.1	2.0	1.4	0.8	4.3	1.4
State and Local	174.9	175.1	175.2	-0.7	0.0	-1.5	-1.9	1.9	-0.3	1.0	1.1	0.2	0.1	0.1

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

in bank loan demand has contributed to the weak monetary growth. Given the poor outlook for business activity until well into the first half of next year, loan demand and money supply growth will remain constrained until then. Interest rates can therefore be expected to decline further throughout this period. Moreover, the expected weakness of the economic recovery will tend to dampen the pace of interest rate increases when they finally do turn upward.

Although somewhat different in nature, the present recession will approximate the previous one in severity. It is still relatively early in the downturn, and economic statistics will continue to reflect a deteriorating situation for many more months. Corporate profits will show much sharper deterioration in the months ahead as the inability of businesses to raise prices in a weakening economy squeezes profit margins.

Moreover, the outlook for the housing and auto industries, the two sectors which have led the way into this recession, remains relatively bleak. Declining mortgage rates, while having a positive influence on the housing market, will not give much assistance to new housing starts in 1980. A large inventory of resale houses combined with seasonal factors and construction start-up lags will push the beginning of the housing recovery well into 1981. The auto industry will introduce its 1981 models in the depths of recession. While increased variety and availability of fuel-efficient models will help Detroit in 1981, the recession and consumer knowledge of further major changes in auto technology due in the near term will continue to depress auto sales.

In general, the outlook now is for an "L-shaped" recession as opposed to the "U-shape" of the previous recession. The unemployment rate, which peaked at nine percent in 1975, will peak nearer ten percent next year due in large part to the tremendous growth of employment over the past five years as labor was substituted for capital.

Consumer price increases, after slowing in the summer months, will begin rising more rapidly in the fourth quarter as food prices begin to accelerate from the relatively low levels seen so far this year. As mentioned previously, continuing inflationary pressures will make a recovery in consumer spending that much more difficult to achieve.

A long and deep recession is now well under way. Its causes are understandable and its eventual end is certain. But, right now, the water seems awfully cold.

Dr. Richard S. Smith
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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

U.S. Agriculture in the Eighties

August 21, 1980

Highlights

- **World population trends suggest continuing strong demand for food. Oil-price increases, inflation and a slowdown in world economic growth, however, will put a lid on potential demand in the next few years.**
- **By the mid-1980s, world demand for agricultural products will be on a strong upward trend. The United States will be in a good position to capture a large share of this increase.**
- **Although demand for agricultural output will in general press against productive capacity, favorable net returns for farmers are not guaranteed. Farm margins will continue to be squeezed by rising input costs. To cope, farmers will need to adopt cost-savings technology, spread farm machinery costs over larger numbers of acres and carefully plan their marketing strategies.**
- **The grain reserve will tend to place a ceiling and floor on crop prices, however, considerable volatility will exist since the United States will continue to be a residual supplier of food to the world.**
- **The cattle cycle has entered the rebuilding stage. The next few years should be profitable for both cattle ranchers and beef feedlots. By the mid-1980s, livestock numbers will again reach record levels in the United States, resulting in strong domestic demand for feed grains. Beef processors will benefit from increased volumes.**
- **Recovery in farm income will cause a strong rebound in farm machinery and equipment sales across a broad range of products. Farm consolidation suggests that the trend toward larger, more productive machinery will continue.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

The huge swings in agricultural commodity prices during the past seven months dramatize the volatile nature of American agriculture. Earlier this year farmers had to contend with weak demand for farm products, surging farm production costs and plummeting farm income.

Fortunately, agricultural conditions have changed significantly since this past spring. Aided by a heat wave which settled in the southern portion of the nation, farm prices rose dramatically during July. Although prices may ease as crop prospects become more certain, recent increases in loan rates and related release levels for the grain reserve will limit the possible decline. Accordingly, farm income prospects have improved substantially.

Of course, there still are the "haves" and "haves nots" depending on whether individual farmers were spared the extreme drought conditions. Overall, however, agriculture appears to be on the road to recovery. What is in store for the rest of the decade? What obstacles lie around the bend? How prosperous will agriculture be?

Demand For Food

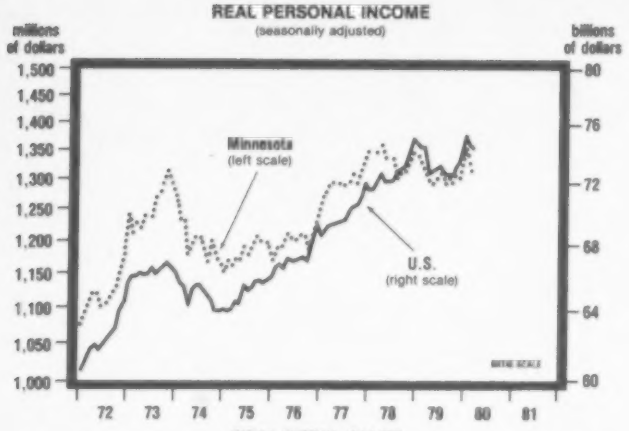
Rising population, income growth and related efforts to upgrade diets are the major factors behind the long-run growth in world demand for food. Demand for food grains is particularly responsive to population growth in developing countries, while demand for meat and consequently demand for feed grains is more directly related to income prospects in developed countries.

According to the U.S. Census Bureau's Series II medium population projections, total world population is expected to reach 5.34 billion by 1990, up nearly 900 million from 1980, with the vast bulk of this growth occurring in the developing countries. Such population growth suggests continuing strong demand for food, however, the level of income will put a lid on potential demand at least in the next few years. Those developing countries that must import petroleum are experiencing balance of payments difficulties. At the same time, inflation and an economic downturn will limit income gains in the industrialized countries. Partially offsetting this will be increased demand by the oil-rich countries and the high-income developing countries such as Taiwan, South Korea and Hong Kong.

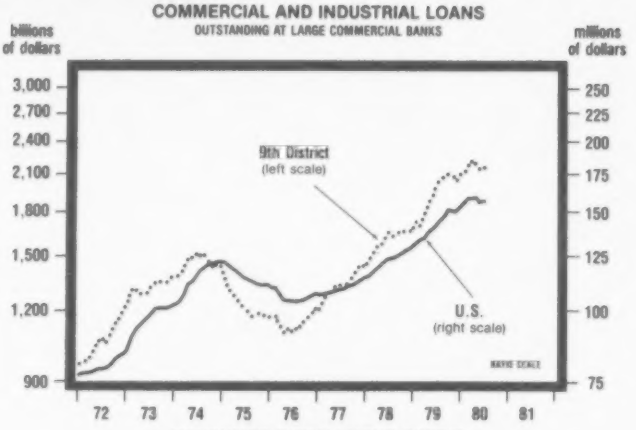
The greatest uncertainty and, at the same time, the largest potential for expansion in world food demand lies in the centrally planned countries. Agricultural production in countries such as the Soviet Union and China will not keep up with long-term food needs. Although the demand for U.S. products will be hampered by the desire to avoid high dependence on the United States, our exports to the centrally planned countries will expand. Trading relations with the Soviets probably will be normalized in the

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME
(seasonally adjusted)

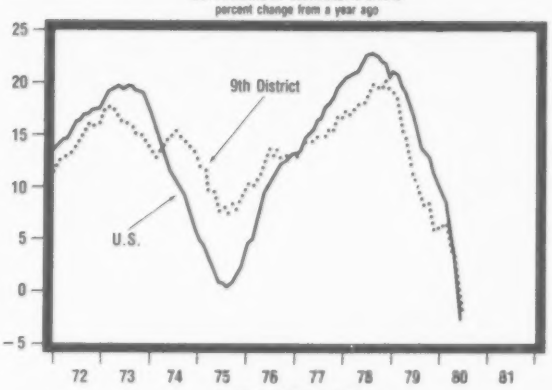


COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS

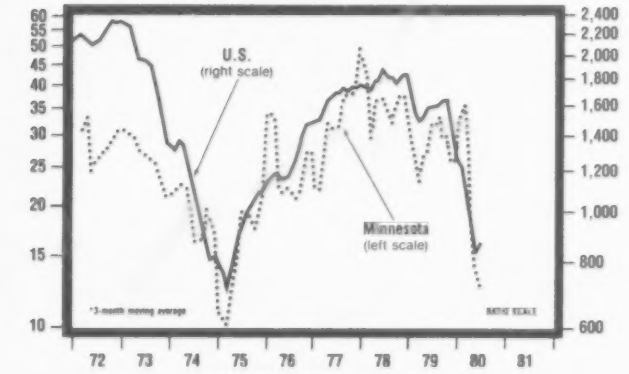


REAL RETAIL SALES
(seasonally adjusted)

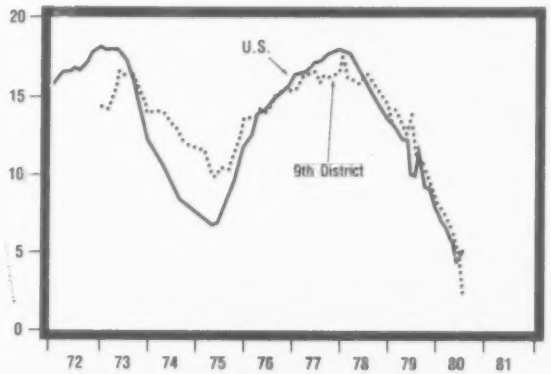
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



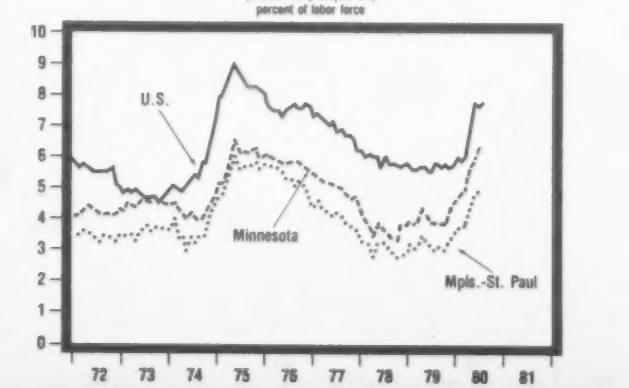
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



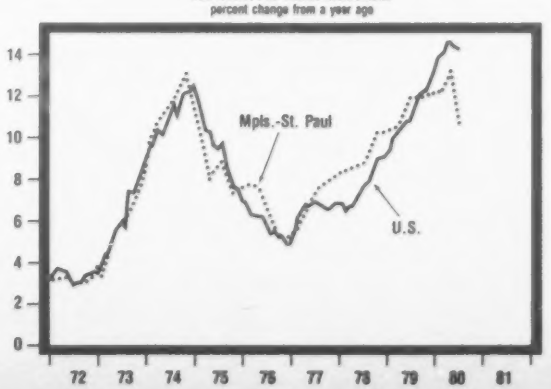
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



early 1980s. Due to erratic Soviet grain production, however, variability will continue to characterize these trading relations.

Although domestic food demand will also expand, U.S. agriculture will become increasingly dependent on international markets for its well-being. As the decade progresses, world economic recovery and continued population growth will stimulate demand for food. By the mid-1980s, world demand for grains, oilseeds, fiber and livestock products will be on a strong upward trend. The United States will be in a position to capture a large share of this increase. Thus growing farm exports will fuel the boom in total sales of farm products.

Crops

The growth in demand for agricultural output in the 1980s, though slower than the 1960s and early 1970s, will in general press against productive capacity. To be sure, periods of excess supply may still emerge. For example, such a situation could arise if back-to-back abundant Soviet grain harvests occurred simultaneously with favorable U.S. crop production.

Unfortunately, the prospect of crop production running close to full capacity does not necessarily mean that farmers will be guaranteed favorable net returns in the 1980s. Farm margins will continue to be squeezed by rising input costs such as fuel and fertilizer.

The successful operator will be one who adopts cost-saving technology, spreads farm machinery costs over larger numbers of acres, increases crop yields through use of agricultural chemicals and new varieties of seed, and adopts a well thought out crop marketing program.

There will be increased economic incentives to adopt energy-efficient systems of production. Even greater stress will be placed on minimum tillage combined with increased use of chemicals for weed control. The relative competitive position of those regions dependent on irrigation will tend to diminish. New methods of irrigation will be adopted to mitigate the effects of higher energy costs and limited supplies of water.

Transportation problems and wide regional variations in grain prices will continue during the eighties. While approval has finally been given to proceed with improving Locks and Dam 26 at Alton, Illinois, completion is expected to take up to 10 years. Meanwhile, farming regions served by the Upper Mississippi will have to utilize more expensive modes of transportation to export markets. There will be increased incentives to market grain through elevators which obtain or maintain access to unit trains.

The Food and Agricultural Act of 1977, the basis for current farm programs, will expire in 1981. The upward push in farm input prices will be translated into political pressure to develop a formula for increasing loan rates and target prices more rapidly in the 1980s than was the case in the late 1970s. In general terms, however, the eighties will bring only marginal changes in farm legislation.

For exportable commodities such as grains, soybeans and cotton, government loan rates will tend to be set slightly below the longrun world equilibrium price trend. This will facilitate the export of farm commodities while at the same time providing some price protection for a highly cyclical industry.

The farmer-owned grain reserve will remain a fundamental part of agricultural policy and may be expanded during the 1980s. The grain reserve will be relied upon to prevent large price declines during periods of excess supply as well as rapid escalation in times of crop shortfalls. Although the grain reserve will tend to place a ceiling and floor on crop prices, commodity prices still will exhibit a fair degree of volatility since the United States will continue to be a residual supplier of food to the world.

No major changes are anticipated in farm structure during the 1980s other than those implicit in the trends that have prevailed over the past several decades. Although public debate is likely to focus on the trend toward larger farms and the separation of ownership and use of farmland and other agricultural resources, the trend toward fewer and larger farms and the increasing importance of capital in agriculture will continue.

Wheat: The projected population growth and rising living standards in developing countries bode well for long-term demand for wheat. The gap between foreign production and consumption will continue to widen in the 1980s. In the next few years, however, balance of payments pressures in oil importing developing countries will dampen export growth. Thus the extend of food assistance will influence the growth of U.S. wheat exports in the early 1980s. As the decade progresses, wheat exports are expected to rise fairly rapidly leading to an upward trend in wheat prices.

Corn: Inventories and prices of corn are directly influenced by the U.S. livestock industry which utilizes around 75 percent of our corn production. During the next year, domestic utilization will slow in response to reduced livestock production. Export demand will also be sluggish, reflecting slower economic growth in the industrialized countries.

In a few years, however, demand for feed grains will be on a strong upward trend. On the domestic side, a major expansion in livestock feeding is anticipated with total grain consuming animals reaching record levels by the mid-1980s. The use of corn in the production of gasohol will also increase. Nevertheless, at least during the early part of the decade, it seems unlikely that gasohol will account for a very significant portion of U.S. grain production. Growing domestic utilization of corn will be joined by strong export demand as the industrialized countries recover from the current economic slowdown. Thus, an upward trend is expected in corn prices and acreage during the 1980s.

Soybeans: The anticipated expansion of livestock feeding in the United State will provide an expanded market for soybeans in the 1980s. Export opportunities will also continue to grow. However, due to increased world competition and competition from alternative oil sources, U.S. soybean exports will not expand as rapidly as in the 1970s. Consequently, soybean prices are not expected to rise as rapidly as in the past decade.

The Soviet Union provides a potentially growing market for soybeans. Currently, the Soviet Union accounts for about 15 percent of the world's grain usage but only eight percent of oilseed use. Increased usage of protein meal would yield more efficient feeding rations for the Soviet livestock industry. In order to stretch their feed supplies during the U.S. grain embargo, the Soviets have already increased their purchases of soybean meal processed in western Europe.

Livestock

Beef: The largest liquidation of beef cattle in history has ended. The rebuilding phase of the cattle cycle is expected to start in earnest in 1981, with cattle numbers continuing to rise until at least 1986, a longer rebuilding phase than normal. Even so, the next peak in cattle numbers may not reach the previous peak level.

Drought conditions could slow the build-up in the beef herd. In addition, the high cost of re-entering the cattle industry will make south-eastern producers reluctant to get back into the business. Nevertheless, the July 1 USDA cattle inventory report confirmed that the cattle cycle is indeed turning. The early years of this expansion phase should be profitable for both the cow-calf operator and the cattle feeding business.

Relatively low grain prices in the western portion of the corn belt will tend to counteract the climatic advantages, and hence lower fixed costs, enjoyed by the large commercial feedlots in the southwest. As a result, specialized feedlots in the western corn belt region may grow in importance during the 1980s.

Hogs: Although the increase in confinement feeding along with higher capital investment costs will dampen the fluctuations, the hog cycle will still be part of agriculture in the 1980s. Recently depressed hog prices will result in a liquidation of hogs during the next couple of years, with the rebuilding phase starting by 1982.

Due to relatively low feed grain prices, hog production will increase in importance in the western portion of the corn belt. Studies have shown that over a five to ten year period, corn belt hog farms have experienced higher returns to investment than any other major farm operation. Diversification into livestock production may become essential for the beginning farmer.

Agri-Business

Given the trends discussed earlier, how will the suppliers of agricultural inputs and the processors and distributors of agricultural goods fare in the 1980s?

Input Suppliers: Farm machinery sales are closely tied to changes in farm income. The recent increases in farm prices and the anticipated significant recovery in farm income is expected to result in a strong rebound in farm machinery and equipment purchases during the next couple of years. Part of this strong demand will arise from a bunching of purchases which were postponed earlier this year.

Continued farm consolidation suggests that the trend towards larger, more productive machinery will continue. This allows farmers to plant and harvest crops rapidly, shortening the period of good weather required for these operations.

In the recent past, farm machinery sales have been the strongest for the largest size units such as four wheel drive tractors. Sales have also been heavily weighted towards the wheat belt. An improvement in corn and soybean prices relative to wheat could stimulate demand across a broad range of products, particularly in the corn belt.

Strong demand is also expected for fertilizer and other agricultural chemicals. In general, emphasis will be given to those farm inputs or technologies which either reduce production costs or increase yields.

Commodity Processors: From the standpoint of supply, the operating environment for beef processors will improve as the rebuilding stage of the cattle cycle picks up momentum. Slaughter volume will again reach high levels by the mid-1980s. Industry concentration levels are likely to increase. In addition, due to advantages in transportation and more efficient use of labor, more beef will be pre-cut at packing plants.

During the next couple of years, pork processors will be faced with declining slaughter volumes and higher prices as hog production declines from current peak levels. This situation will be reversed again as hog production reaches another peak around 1985.

Although not matching the growth experienced in the last five years, continued growth is expected in the broiler industry. Both the broiler and turkey industries will focus on further processing of products.

For non-livestock processors, sales and profits will be tied closely to the price and availability of raw materials. A substantial rise in world sugar prices during the past year, has been a big plus for the corn sweetner industry. During the next few years the industry is expected to continue to benefit from higher sugar prices. Thus, despite the recent increase in corn prices, margins are expected to remain favorable.

Expansion of production facilities could eventually put the industry into overcapacity, especially as world sugar production starts to increase again. However, additional substitution of high fructose corn syrup in soft drinks could lead to continued strong demand. In addition, increased fuel alcohol capacity could benefit the corn processing industry by providing a contra-seasonal demand to the sweeteners used extensively in canning and soft drinks.

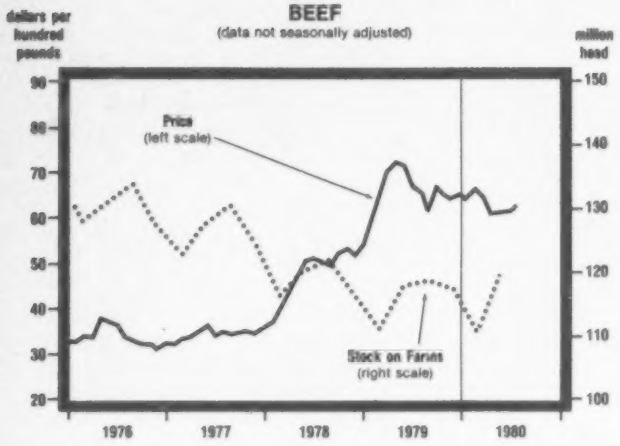
Soybean processors are expected to experience continued growth in demand during the 1980s. At the same time the domestic market for sunflower oil will expand, stimulating the construction of additional processing plants in the United States.

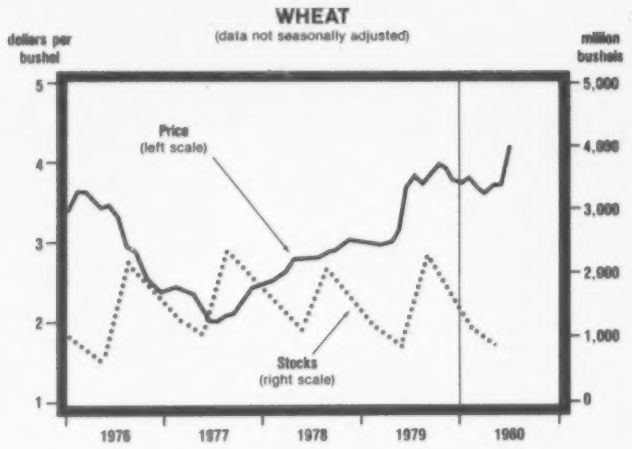
Grain Merchandising: World economic conditions may slow the growth of export demand during the next year. However, the longer-term outlook is for continued strong growth of grain and soybean exports.

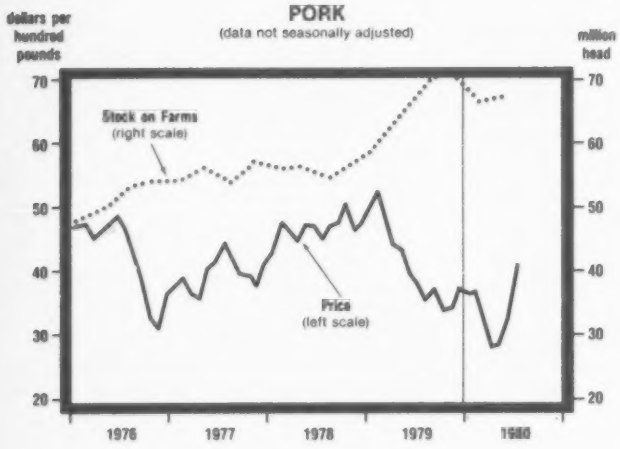
Our exports will continue to be subject to the vagaries of weather and government policy. Since the United States is essentially a residual supplier in the world markets, commodity prices will tend to be fairly volatile. However, the grain reserve program will be relied upon to reduce the magnitude of these fluctuations.

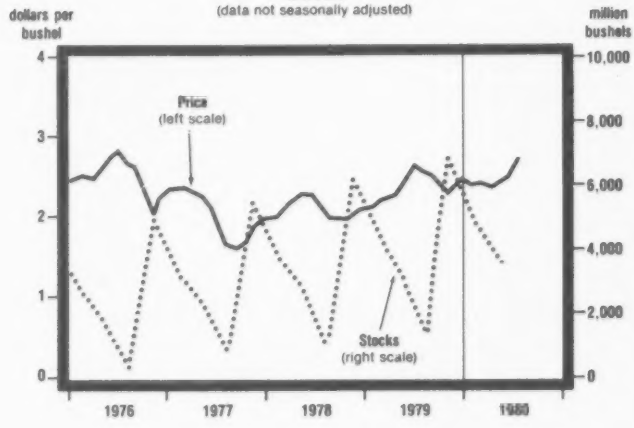
Dr. Larry J. Wipf
Assistant Vice President
Director of Regional Economics

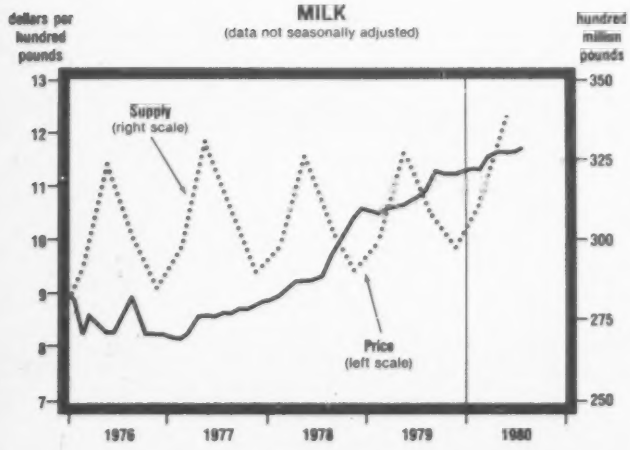
AGRICULTURAL CONDITIONS

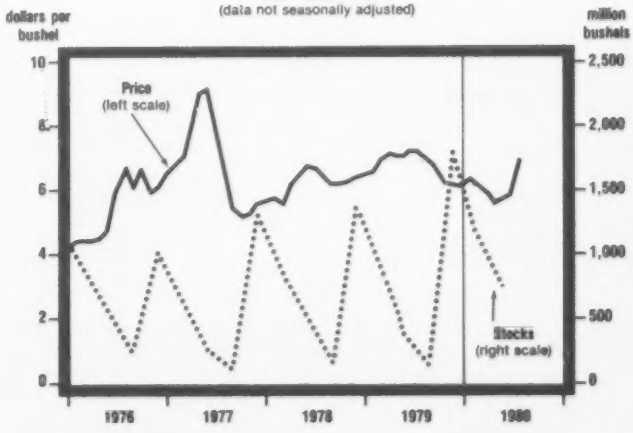












northwest economic
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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

International Outlook

September 24, 1980

Highlights

- **The two-fold problem of inflation and recession is again afflicting the world economy. The end of a normal cyclical expansion combined with the recent doubling of oil prices has once again put most of the oil importing free world countries in an economic squeeze.**
- **Each of the free world's major industrial economies is weakening. The degree of weakness differs substantially between countries, however, ranging from true recession in the United States and the United Kingdom to still-enviable strength in Japan**
- **Current account balances of the Organization of Petroleum Exporting Countries (OPEC) are likely to double this year to $115 billion. A low OPEC capacity to absorb imports and high external debt levels of many oil importers could make the petrodollar recycling process difficult.**
- **The greatest relative burden of stagnating economic growth and sharp oil price increases again rests on the non-OPEC lesser developed countries. The ability of these countries to contract their economies in response to adverse world economic events is much less than that of the industrial countries.**
- **Possible economic crises in some lesser developed countries, generated by current world economic conditions, could result in disruptive political and social changes. Consequently, financial assistance to these countries during this difficult period remains necessary. The source of this assistance is of secondary importance.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Declining rates of economic growth, debilitating inflationary pressures, volatile currency and interest rate movements, and the second round of major OPEC price hikes characterize the entry of the non-OPEC free world economy into the decade of the 1980s.

The overall economic climate confronting the world at present thus strongly resembles that which prevailed in late 1974 and 1975. Stagflation, the twin dilemma of inflation and economic stagnation, is once again afflicting the world's largest economies. Moreover, the economic health of many of the lesser developed countries is threatened by the rising cost of energy imports and the softening of economic activity in the industrial countries.

The years between 1975 and 1980 saw strong recoveries in most economies and an accommodation on the part of world financial markets to the balance-of-payments difficulties which arose in the wake of the first round of OPEC price increases. The question now is whether economic history will repeat itself. Although the similarities of the present period to 1974-75 are plain, certain important differences also exist.

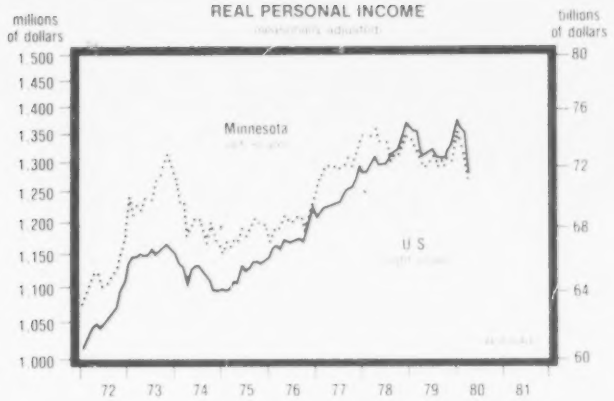
The Industrial Countries

Economic conditions and policy stances in the U.S. have been a major determinant of economic policies in most of the other member countries of the Organization for Economic Cooperation and Development (OECD) this year. Moreover, this relationship is likely to continue on into 1981.

The industrial countries of Europe and Japan have historically been very sensitive to the adverse economic effects of inflation. In addition, given the relatively high dependence of these countries on imports, the inflationary effect of a weakening of their currencies has been of particular significance to them. A weak currency also makes it more difficult for a current account deficit country to attract capital inflows to offset that deficit.

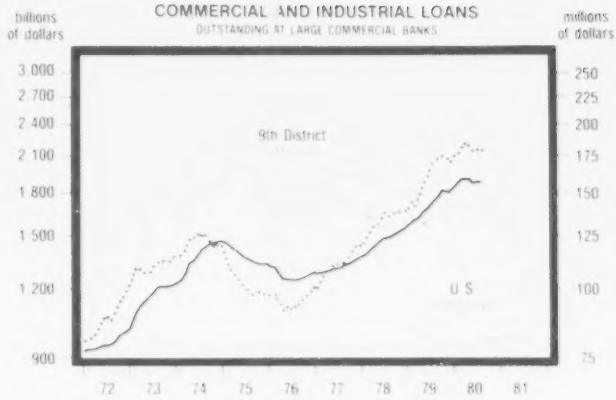
REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME



COMMERCIAL AND INDUSTRIAL LOANS

OUTSTANDING AT LARGE COMMERCIAL BANKS

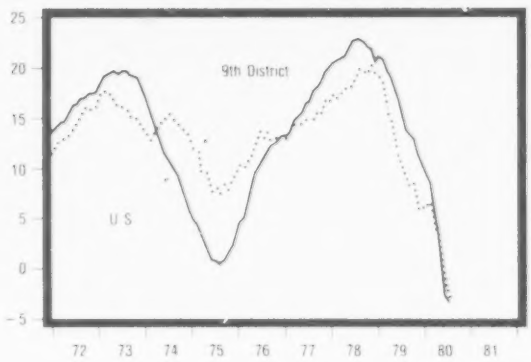


REAL RETAIL SALES

CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

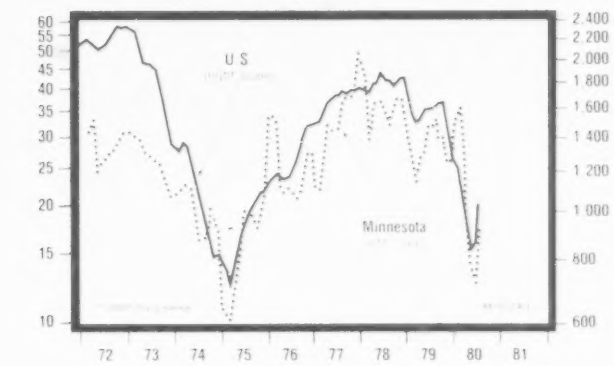
percent change from a year ago



HOUSING UNITS AUTHORIZED

HOUSING UNITS AUTHORIZED BY BUILDING PERMITS

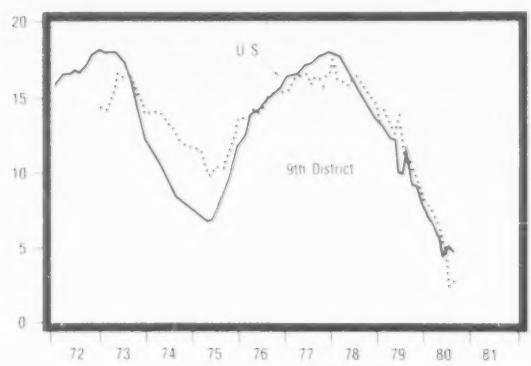
thousands of units



MORTGAGE LOANS

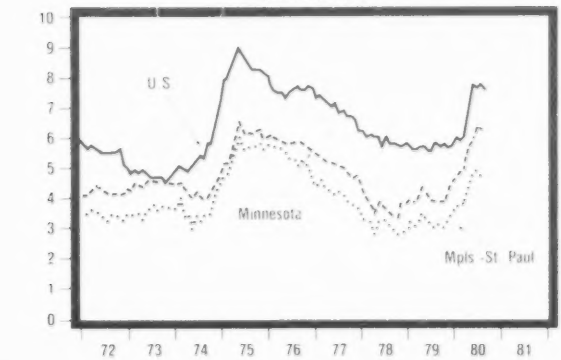
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

percent change from a year ago



UNEMPLOYMENT RATES

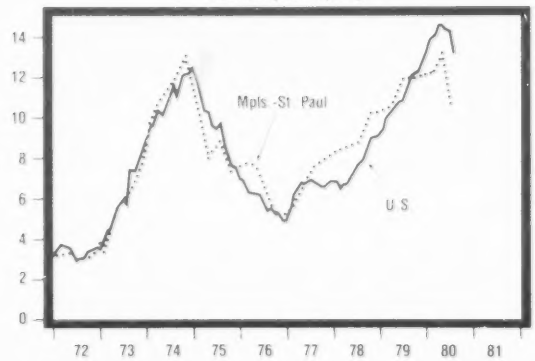
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS ALL URBAN CONSUMERS

percent change from a year ago



These relationships explain the reasoning behind the almost universal trend among the non-U.S. OECD countries this year toward restrictive monetary policies. The doubling of oil prices by OPEC at the end of last year had a highly inflationary impact on the major OECD countries. Moreover, it was necessary for these countries to take every possible action to protect the value of their currencies relative to the dollar. Since oil is priced and generally paid for in dollars, any slippage in the value of a non-dollar currency implies a magnified inflationary impact of the oil price increase for the country whose currency is weakening.

In general, Europe and Japan were hit with a one-two punch early this year — a doubling of OPEC prices in dollar terms combined with rapidly rising interest rates in the U.S. as a result of the Federal Reserve's efforts to dampen severe inflationary pressures in this country. Consequently, these countries were left with no alternative but to employ restrictive monetary policies for defensive purposes. Money and credit growth were checked and interest rates elevated despite the fact that most countries, excluding the United Kingdom, had not yet exhausted their economic expansion possibilities for the current business cycle. Inflation control took precedence over the maintenance of a strong growth path. Moreover, when U.S. interest rates dropped as sharply in the second quarter as they rose in the first, foreign interest rates remained high as the other OECD countries sought to further contain the inflationary pressures of the first quarter and to attract capital to offset seriously deteriorating current account positions.

To a large extent, inflationary pressures generated by events earlier this year have been reasonably contained in continental Europe and Japan. While the restrictive monetary policies of the first half of 1980 have indeed begun to soften economic activity in general overseas, the successful containment of inflation is now expected to lead toward more stimulative measures in Europe and Japan.

A resumption and continuation of the downward trend in interest rates

Growth of Real GNP

percent changes, seasonally adjusted annual rates

	From previous year			From previous half-year		
	1978	1979	1980	1980:I	1980:II	1981:I
Japan	6.0	5.9	5.5	6.0	3.75	3.75
Germany	3.5	4.4	2.0	2.25	-1.25	1.0
France	3.3	3.2	2.0	1.75	0.75	0.5
United Kingdom	3.5	1.7	-2.25	-2.0	-4.5	-1.0
Canada	3.4	2.9	0.25	0.25	-1.0	2.0
Total OECD	3.9	3.4	1.25	1.50	-1.0	1.0

Source: OECD

Private Consumption Price Deflator

percent changes, seasonally adjusted annual rates

	From previous year			From previous half-year		
	1978	1979	1980	1980:I	1980:II	1981:I
Japan	4.2	3.1	7.5	8.0	8.5	6.25
Germany	2.6	4.2	5.0	5.25	4.0	3.5
France	9.3	10.7	13.25	14.25	12.0	11.0
United Kingdom	8.7	12.0	18.75	18.5	18.0	14.25
Canada	7.3	9.0	9.5	9.0	10.0	10.0
Total OECD	7.2	8.5	11.25	12.0	11.0	9.5

Source: OECD

in the U.S. will allow other OECD governments and central banks to relax their restrictive stance. But, the recent backup in rates in the U.S. has undoubtedly generated substantial concern overseas. Should the upward movement in U.S. interest rates prove to be other than very temporary, expansionary measures overseas may have to be postponed. The result would be that general non-U.S. OECD growth could be even weaker through 1981 than is now expected. While this is not considered a likely scenario at present, the risk cannot be ignored.

While generalized weakness will characterize the industrial countries through 1981, recently released OECD forecasts suggest that the degrees of both weakness and inflationary pressure are likely to vary substantially between countries.

Japan's economic performance is expected to be the strongest of the OECD countries through next year. Real economic growth in the three to four percent range through next year will be largely generated through strong exports. The country's export strength is being maintained during the generalized world economic downturn because of the strong improvement in its international competitiveness. This has resulted both from favorable exchange rate movements and strong productivity increases. Inflation should peak at about 8.5 percent by the end of this year and decline moderately through 1981. The country's current account, in surplus by $16 billion as recently as 1978, will show an oil-induced deficit of more than $17 billion in 1980.

While **Germany's** real gross national product is likely to decline at a one percent annual rate in the second half of 1980, the country will still show real growth of about two percent for the year as a whole. Inflation, now running at about a five percent annual rate, should decline further through next year in line with the expected very sluggish economic recovery. Germany is likely to post a current account deficit of $16 billion this year, compared to a surplus of $8.7 billion in 1978.

France will experience generalized softness throughout its economy

through the coming year although real growth rates are expected to remain slightly positive. Inflation, running at a 14 percent annual rate in the first half of this year, should decline to the 11 percent range by mid-1981. France also has been severely affected by rising oil prices and will post a current account deficit of approximately $4 billion this year.

Very tight monetary and fiscal policies instituted by the conservative Thatcher government have led to a genuine recession in the **United Kingdom.** This recession is expected to continue through the middle of next year with the sharpest annual rate of economic decline, 4.5 percent, taking place in the second half of this year. Inflation, currently running in excess of 18 percent, is proving difficult to control due largely to labor reaction against the Government's austerity measures. The rate of price increase is likely to decelerate only to the 14 percent range during the first half of next year. Exports of North Sea oil and soft import growth are helping the country's current account balance, however. The $2.5 billion current account deficit expected this year compares favorably with the $5.2 billion deficit posted last year.

Canada, as usual, remains heavily influenced by economic activity in the United States. A one percent decline in real GNP in the latter half of this year should be followed by growth at a two percent annual rate in the first half of 1981. Inflation is expected to remain a problem, with consumer prices rising by 10 percent in the year ending next June. This is up from a nine percent increase in prices in 1979. A current account deficit of $5 billion will likely be experienced this year with some additional current account deterioration in the first half of 1981. Canada's trade position will remain adversely influenced by soft conditions in the economy of the United States, its chief trade partner.

In summary, assuming that most OECD countries can soon begin to institute some stimulative measures, this year and next year will see growth slowdowns short of actual recessions in most countries followed by sluggish recoveries. Throughout the industrial world, the inflationary pressures caused both by a five-year period of economic expansion and adjustment to the most recent transfer of real income to the oil exporting countries will make the resumption of strong, stable growth difficult to achieve. Despite the economic difficulties now confronting the industrial countries, however, the largest relative burden of adjustment to the latest round of oil price increases rests with those countries least able to afford it — the non-oil lesser developed countries.

The Lesser Developed Countries

As a result of last year's oil price increases, the aggregate current account of OPEC is expected to be in surplus by $115 billion in 1980, more than double the $55 billion surplus of 1979. This rising surplus is, of course, mirrored by corresponding increases in the current account deficits of the oil importing countries, both industrial and lesser developed. Consequently, the problem of petrodollar recycling, or getting the money from the oil suppliers to the oil users, has again surfaced with something of a vengeance.

The OPEC current account surpluses generated by the quadrupling of oil prices in 1973-74 were recycled with a minimum of difficulty. Very rapid growth in OPEC imports in the years immediately following this price rise, coupled with the willingness and ability of the international banking community to extend needed credits to oil importing countries, proved very effective in solving that recycling problem. However, despite that fact that the $115 billion surplus expected this year is not larger in inflation-adjusted terms than the 1974 surplus, the recycling problem is likely to prove harder to solve this time. This represents a very important difference between the current period and the earlier one.

Two basic reasons account for this, with the first being limits on the speed with which the members of OPEC can increase their imports in the years just ahead. The Mideast members of OPEC have very low population densities with commensurately low abilities to absorb large increases in imports. However, these countries together account for about 78 percent of the total OPEC current account surplus expected in 1980. Also, Mideast governments are very aware that the overthrow of the Shah of Iran was at least partially due to the cultural disruptions caused by the Shah's attempt to rapidly industrialize the country. Other Mideast governments will not wish to make the same mistake and, consequently, may hold down the speed with which rising oil revenues are spent on imported goods and services.

OPEC Current Account Surpluses
(billions of U.S. dollars, estimated)

	1979	1980
Saudi Arabia	$16	$41
Kuwait	14	19
Iraq	11	15
United Arab Emirates	5	8
Iran	5	3
Libya	4	14
Other OPEC (net)	0	15
Total OPEC	$55	$115

The second difficulty with the current recycling problem lies with the international banking community's realistic ability to add substantially to its loans to several oil-importing lesser developed countries. Several of the more rapidly growing LDC's are presently faced with the double difficulty of already burdensome external debt loads and additional external financing needs to support the latest round of oil price hikes. The higher risk now associated with lending to these countries is likely to preclude most international banks, who ultimately must account to both their shareholders and various regulatory authorities, from substantially increasing their positions in them.

The burden of recycling is therefore likely to be placed more heavily on governments and multilateral institutions this time around. Substantial increases in direct lending by OPEC members to those countries

most in need of additional financing is not likely to occur. The Bank of England has estimated that 56 percent of OPEC's $236 billion of investments at the end of 1979 were composed of either bank deposits or United States and United Kingdom government securities. Only 16 percent of these investments were in the form of loans to developing countries, either directly or through regional and development agencies. Recent statements on investment policy by OPEC officials strongly suggest that this financial conservatism will continue.

As in the 1974-75 period, then, many non-oil lesser developed countries are again caught in a foreign exchange squeeze. Decreasing rates of economic activity in the industrial countries have dampened demand for lesser developed countries' exports while the doubling of oil prices has substantially increased their import bills. The industrial country reaction to the latest rise in energy prices has been a reduction in the rate of economic growth. Economic forces would also dictate that the lesser developed countries follow a similar course of action. However, the ability to absorb economic cutbacks is far less in the lesser developed countries than in the industrial countries. In several lesser developed countries, forced economic crises could result in violent or otherwise adverse social and political changes. Consequently, every country and institution capable of aiding the recycling process should carefully consider the possible costs of its failure to do so.

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NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Supply Side Economics

October 24, 1980

Highlights

- **For too many years, our economic policy has focused on demand. Price increases have gained momentum. Credit crunches have become periodic occurrences. Each succeeding boom-and-bust cycle has become worse.**
- **As a nation, the United States can not afford more of the same. New and different ideas are needed. In this context, the fallout from supply side economics will be beneficial and productive to us all.**
- **The Reagan-Kemp-Roth proposal does away with the difficulty of selecting specific tax cuts for a subset of the population. It is broad and general enough so that everyone would benefit if it works. On the other hand, it makes the large and risky bet that tax cuts would increase the national output so much that the total revenue would not decline at all or even increase.**
- **The risk could be lowered if tax cuts are accompanied by a combination of non-military spending cuts and/or monetary restraint. Tightening credit conditions could cause some "crowding out" in the capital markets hurting interest sensitive industries, such as housing.**
- **Business tax cuts look most promising. Short-term cost of deficits would be eventually offset by higher output and lower cost of inflation. However, it may take five to ten years before significant benefits result and, we may not have the patience to wait that long.**
- **There is a danger that supply side policies may be called on to do too much. Although supply side proposals are appealing, we should not lose sight of the need to limit the growth of government expenditures as well if inflation is to be tamed.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Adam Smith, the 18th Century apostle of free enterprise wrote, "high taxes, sometimes by diminishing the consumption of the taxed commodities and sometimes by encouraging smuggling, afford a smaller revenue to government than what might be drawn from more moderate taxes." Thus "supply side economics" was born.

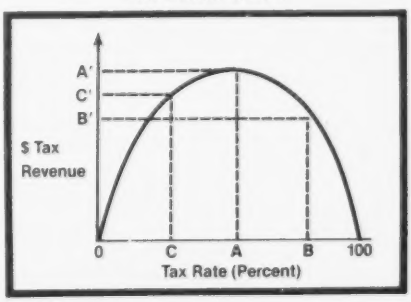
More recently, Colin Clark, the distinguished Australian economist, advanced a similar thesis in the 1940s that a tax-burden in excess of 25 percent would lead to inflation. By then, Keynesian economics with its strong demand orientation overshadowed supply side economics. Clark's advice fell on deaf ears.

A few years ago, the supply side idea was revived by Arthur Laffer, the University of California economist. According to supply side economists, inflation is caused by an excess of demand over supply. Therefore, it is better to reduce inflation by increasing supply than restraining demand. A rising tide raises all ships. In other words, everyone can have more.

The Laffer Curve

Laffer has gained a national reputation by introducing an extreme form of supply side economics, the Laffer curve. He has emphasized the disincentive effects of high marginal tax rates. Tax cuts can bring increased revenues. Laffer has many fans including Carlos Romero Barceló, the governor of Puerto Rico. So enthused was Señor Romero that he has been applying Laffer's ideas to his commonwealth's revenue policies by slashing taxes at a rate of 5 percent per year. Lo and behold, the Island's income tax collection through April of 1980 was 13.5 percent higher than the 1979 rate. Some say that the Puerto Rican experience proves Laffer's theories; others contend that the revenue increased for other reasons.

FIGURE I
The Laffer Curve



The Laffer curve is based on two key assumptions. The first important

ECONOMIC PLATFORM COMPARISONS

Carter	Reagan
TAX CUT COMPONENTS	
• Eight Percent Social Security Tax Credit • "Liberalized" Depreciation • Low-Income Tax Credits	• Three Consecutive Ten Percent cuts in Personal Tax Rates • "Accelerated" Depreciation • Tax Bracket Indexing after 1983
FEDERAL SPENDING	
• Eight billion dollars in countercyclical spending during Fiscal 1981-82 • Major items include $1 billion in unemployment benefits, $1 billion in expanded Revenue Sharing, $3 billion in aid to hard-hit industries and $1.2 billion in aid for the insulation of homes and federal buildings	• Cut Federal spending by at least two percent in each of the next three years and one percent in each of the two subsequent years. No specific cuts announced • Supports transfer of responsibility for Federal Wolfare and Education programs to the states
INFLATION	
• Supports monetary restraint • Target tax incentives to encourage investment and increase productivity • Supports voluntary wage-price guidelines • Favors review of government regulations	• Supports monetary restraint • Tax cuts will increase incentives for productive investment and thus reduce inflation • Supports massive rollbacks in regulation; specific areas not identified
UNEMPLOYMENT	
• Expand Federal job training programs • Tax relief for industries in which there is high unemployment • Proposed an Economic Revitalization Program	• Tax cuts to stimulate growth and employment • Create "urban enterprise zones" to encourage business expansion in depressed areas
ENERGY	
• Emphasize conservation • Support for alternative energy sources (syn-fuels, etc.) • Phased oil and gas price deregulation	• Solution to the energy problem is increased domestic production • Immediate and complete oil and gas price deregulation
HOUSING	
• Expand existing federal housing programs	• Reduced inflation will reduce interest rates and encourage home construction and purchase • Tax exemption for small savers
DEFENSE SPENDING	
• Continue real increases in defense spending of about three percent per year	• Sharply increased defense spending, which would grow to six percent of GNP by 1985
SOCIAL SECURITY NATIONAL HEALTH INSURANCE	
• Fund Medicare through general revenues but retaining existing funding methods for Social Security proper • Supports gradual movement towards National Health Insurance	• Opposes funding any part of Social Security through general revenues, but supports existing benefit levels and entitlement legislation • Opposes National Health Insurance

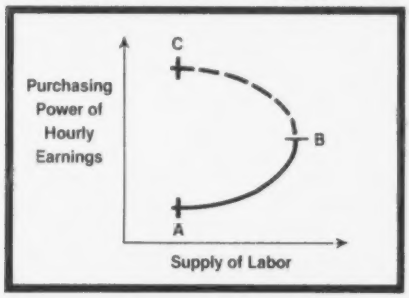
assumption is that the present tax rate is higher than optimal. In Figure I, we see a typical Laffer curve. At a zero tax rate, revenue would be nothing. On the other extreme, revenue would also be zero if earnings are taxed 100 percent. Somewhere in between the two extremes lies an optimal tax rate, A, which would maximize the tax revenue at A.

Unfortunately, according to Laffer, we are at B instead of A. That is, tax rates are too high causing work and investment to be relatively costlier, and leisure and consumption relatively cheaper than they would otherwise be. Our economy is seriously overtaxed. A big cut will unleash enormous additional economic activity, generating more than enough incremental revenue to pay for itself.

However, a goodly number of economists are skeptical about the revenue generating ability of the Laffer curve as it applies to the U.S. economy. Returning to Figure I, we could be at C. Under these circumstances, a huge tax cut would lower revenues, ballooning deficits. Deficits would probably be financed by rolling the printing press exacerbating inflation.

In order for the Laffer effect to occur, the present tax rate must be far enough to the right of the optimal rate, A, so that tax cuts would bring us back to A. If we happened to be to the left of A, like C, then the opposite of the Laffer effect would result.

FIGURE II
Backward-Bending Labor Supply Curve



The second key assumption behind the Laffer curve is that increased purchasing power through tax cuts would lead to increased supply of labor. Stimulated by additional take-home pay, people would be willing to work additional hours. In Figure II, rising purchasing power increases the supply of labor between A and B. People are eager to work more hours as buying power expands. But, the opposite relationship occurs beyond B. Economic literature tells us that people prefer leisure and work fewer hours beyond a certain point like B. Rising purchasing power of hourly earnings through a series of tax cuts might result in people working fewer hours, decreasing the supply of labor.

The implicit assumption behind the Laffer curve is that the U.S. economy is operating somewhere below B. Additional purchasing power would take us closer to B; more purchasing power means more hours-worked and tax revenues.

However, available empirical evidence shows a wide range of results. Donald Fullerton recently wrote in a paper that rising earning power draws women into the labor force, but permits males to retire earlier. The net effect of tax cuts on labor supply is small and the revenue implications are uncertain at best. A Data Resources Incorporated (DRI) model simulation has yielded similar results.

Reagan-Kemp-Roth

Herbert Stein, a respected economist and a former Chairman of the Council of Economic Advisers, has said, "nothing is easier than to find reasons for cutting taxes." The sorry state of the U.S. economy coupled with the election has attracted the attention of many politicians, including Governor Reagan, Congressman Kemp and Senator Roth.

The attention-getting tax cut proposal has become the centerpiece of Reagan's economic policy. Reagan would cut personal tax rates 30 percent over three years (the 10 percent right away is just a downpayment) and then index the tax system to eliminate future inflation-induced increases in effective tax rates.

Most everyone agrees that the Federal tax burden is too great. True enough, it is high. What about the resulting Federal deficit? If one believes in the Laffer curve and his assumptions, tax cuts would increase the national output so much that the total revenue would not decline at all or even increase.

TABLE I

REAGAN-KEMP-ROTH TAX CUT

Changes	1981	1982	1983	1984
Federal Deficit ($ bil.)	-25	-53	-97	-118
Unemployment Rate (%)	-0.5	-1.1	-1.3	-0.8
Inflation Rate (%)	0.1	0.5	1.2	1.8

Table I shows a DRI model simulation of the Reagan-Kemp-Roth Tax Cut. Federal deficits grow to $118 billion by 1984. At least in this particular exercise, the Laffer curve failed us. There are some supply effects, to be sure. The unemployment rate declines as labor supply, productivity and total output increase. However, the increased purchasing power created by the tax cuts increases demand and worsens inflation. By the end of Reagan's first term in office, the inflation rate is raised by as much as two percent.

If inflation is considered to be the nation's number one problem, the overall picture painted by the simulation is not an attractive one. However, there have been other proposals which would make the tax cut proposal workable.

One such proposal is to couple tax cuts with reductions in non-military spending. In this program, incremental deficits would be modest and the job and inflation picture would improve. Unfortunately, this is easier said than done. We have enacted many Federal "entitlement" programs indexed to inflation. The growth of these programs has been reflected in the rising share of payments for individuals and also of grants to state and local governments. Above all, it is prudent to remember that politicians who get specific about spending cuts make more enemies than friends.

Another proposal is to combine non-military spending cuts with monetary restraint. As non-military spending cuts are less than tax cuts, deficits would increase. Monetary restraint would allow the financing of the Federal deficit by crowding out private borrowers. Interest rates would be bid up. Credit sensitive industries, such as housing, would be worse off. Nevertheless, total output would increase creating jobs and the price picture would improve.

Offsetting spending cuts and monetary restraints are not the only alter-

ECONOMIC OUTLOOK

October 1980

Improving Price Trend

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change**		
	1979	1980E	1981E	1980E				1981E				1979	1980E	1981E
				I	II	IIIE	IVE	IE	IIE	IIIE	IVE			
Consumer Price Index (1967 = 100)	217.6	247.0	270.7	16.9	13.7	8.5	10.7	9.2	9.1	8.8	9.6	11.3(12.8)	13.5(12.4)	9.6(9.2)
Food	234.9	254.9	284.5	6.0	6.4	13.5	16.0	11.2	10.5	10.0	9.0	10.9(10.0)	8.5(10.4)	11.6(10.2)
Nonfood Commodities	195.0	221.7	239.6	20.5	9.4	8.0	7.7	7.2	8.6	8.0	10.0	11.7(13.9)	13.7(11.3)	8.1(8.5)
Services	234.4	269.9	296.2	18.6	21.7	4.0	11.0	10.0	9.0	9.0	9.5	11.0(12.8)	15.2(13.6)	9.7(9.4)
Producer Price Index, Finished Goods (1967 = 100)	216.1	245.9	273.0	17.6	10.3	15.0	11.0	9.2	11.2	11.0	11.1	11.0(12.6)	13.8(13.4)	11.0(10.6)
Compensation Per Manhour, Nonfarm Private (1967 = 100)	247.6	271.7	299.5	10.9	10.8	8.5	10.0	11.0	10.5	10.0	10.0	8.8(9.0)	9.7(10.1)	10.2(10.3)
Labor Productivity, Nonfarm Private (1967 = 100)	115.5	114.5	115.1	– 1.0	– 2.8	0.4	2.0	– 1.0	1.5	1.0	2.0	– 1.3(– 2.0)	– 0.9(– 0.3)	0.5(0.9)
Unit Labor Costs, Nonfarm Private (1967 = 100)	214.3	237.4	260.4	12.1	14.0	8.1	8.0	12.0	9.0	9.0	8.0	10.2(11.3)	10.8(10.5)	9.7(9.5)
Corporate Profits After Taxes, bil. $	144.1	139.5	137.7	33.8	– 58.1	40.0	– 10.0	– 12.6	10.0	25.0	15.0	18.6(11.0)	– 3.2(– 8.3)	– 1.3(8.4)
Disposable Personal Income, bil. $ (1)	1624.2	1784.3	1965.5	13.5	4.3	10.5	10.0	10.0	10.0	12.0	13.0	11.4(10.4)	9.9(9.5)	10.2(11.2)
Real Disposable Personal Income, bil. $ (2)	746.4	722.4	726.1	– 2.9	– 8.2	1.7	– 0.6	0.7	0.8	2.9	3.2	0.1(– 2.1)	– 3.2(– 2.5)	0.5(1.9)
New Passenger Car Sales (millions of units)	10.7	9.1	9.4	10.7*	7.7*	8.9*	9.0*	8.7*	9.2*	9.5*	10.0*	10.7*	9.1*	9.4*
New Private Housing Starts (millions of units)	1.7	1.3	1.6	1.3*	1.1*	1.3*	1.4*	1.2*	1.6*	1.7*	1.8*	1.7*	1.3*	1.6*
Unemployment Rate, %	5.8	7.3	8.5	6.1*	7.5*	7.6*	8.0*	8.5*	9.0*	8.3*	8.0*	5.8*	7.3*	8.5*
Federal Government Deficit, bil. $	11.4	51.8	61.3	22.9*	49.2*	65.0*	70.0*	80.0*	70.0*	50.0*	45.0*	11.4*	51.8*	61.3*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

**Numbers in parentheses are 4th quarter-to-4th quarter percent changes.

ECONOMIC OUTLOOK (Without Inflation)

October 1980

Double Dip Recession—Sluggish Recovery

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change**		
	1979	1980E	1981E	1980E I	1980E II	1980E IIIE	1980E IVE	1981E IE	1981E IIE	1981E IIIE	1981E IVE	1979	1980E	1981E
Gross National Product	1431.6	1420.1	1429.0	1.2	−9.6	0.4	2.0	−3.6	5.4	3.9	4.5	2.3(1.0)	−0.8(−1.6)	0.6(2.5)
Consumer Expenditures	924.5	925.4	940.1	0.5	−10.5	6.2	2.1	0.3	1.9	3.6	4.2	2.6(1.6)	0.1(−0.6)	1.6(2.5)
Durables	147.2	135.9	138.3	−3.5	−41.1	25.0	4.0	−5.2	6.0	10.5	10.3	0.3(−3.6)	−7.7(−7.3)	1.8(5.2)
Nondurables	349.1	350.6	354.5	−1.1	−6.9	2.0	1.5	1.0	1.0	3.0	4.0	1.7(0.9)	0.4(−1.2)	1.1(2.3)
Services	428.3	438.9	447.3	3.2	−1.3	4.5	2.0	1.5	1.5	2.0	2.5	4.3(4.2)	2.5(2.1)	1.9(1.9)
Investment	215.2	187.6	180.9	−8.4	−25.8	−21.0	7.2	−27.1	36.5	10.3	12.2	0.4(−4.5)	−12.8(−12.9)	−3.6(5.4)
Fixed Residential (1)	56.7	44.0	45.0	−26.3	−61.6	6.0	12.0	−10.0	22.1	25.1	30.6	−5.7(−7.0)	−22.3(−23.8)	2.2(15.8)
Fixed Nonresidential (2)	148.8	144.6	135.3	1.9	−14.7	−10.1	−3.0	−15.1	0.3	0.8	3.4	6.2(3.4)	−2.8(−6.7)	−6.4(−2.9)
Structures	48.1	48.8	44.9	1.6	−9.2	−7.0	−4.8	−15.2	−6.7	−3.4	−2.1	9.6(7.7)	1.4(−5.0)	−8.1(−6.9)
Producers Durable Equipment	100.7	95.8	90.4	2.0	−17.0	−12.0	−2.0	−15.0	4.0	3.0	6.2	4.6(1.5)	−4.8(−7.6)	−5.6(−0.9)
Change in Inventories	9.7	−1.0	0.6	0.3*	2.6*	−5.0*	−2.0*	−9.0*	2.3*	4.0*	5.1*	9.7*	−1.0*	0.6*
Net Exports (3)	17.6	27.4	28.0	25.0*	28.4*	28.0*	28.0*	28.0*	28.0*	28.0*	28.0*	17.6*	27.4*	28.0*
Exports	119.9	128.0	128.3	131.7*	128.3*	126.0*	126.0*	126.0*	128.0*	129.0*	130.0*	119.9*	128.0*	128.3*
Imports	102.3	100.7	100.3	106.7*	99.9*	98.0*	98.0*	98.0*	100.0*	101.0*	102.0*	102.3*	100.7*	100.3*
Government Purchases	274.3	279.8	279.9	4.3	1.3	−1.7	−1.4	0.1	0.9	1.4	1.2	0.4(0.4)	2.0(0.6)	0.0(0.9)
Federal	99.4	105.7	107.2	13.3	9.5	−2.5	−1.3	2.0	3.0	2.0	1.4	0.9(1.8)	6.3(4.5)	1.4(2.1)
State and Local	174.9	174.2	172.8	−0.7	−3.1	−1.5	−1.5	−1.0	−0.3	1.0	1.1	0.2(−0.3)	−0.4(−1.7)	−0.8(0.2)

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

**Numbers in parentheses are 4th quarter-to-4th quarter percent changes.

natives. The Reagan-Kemp-Roth tax cuts could be matched by increases in other taxes, such as a new gasoline tax. Proponents of the proposal argue that such a scheme would cut waste, like unnecessary gasoline consumption, without materially harming economic activity. The additional tax would result in a one-time increase in the Consumer Price Index. However, the combination of tax cuts and increases would eventually have desirable effects on inflation and jobs.

Business Tax Cuts

A tax cut is justified if long-term benefits from the cut outweigh short-term costs. A good example is business tax cuts designed to spur lagging investments in plant and equipment and raise productivity. Short-run costs in terms of deficits and inflation would be more than offset by favorable economic outcomes.

There are a couple of such interesting proposals receiving attention. The first one is the Jones-Conable "Capital Cost Recovery Act." Tax lives would become ten years for structures, three years for cars and light trucks and five years for other equipment (10-5-3). The second proposal has a more moderate change in depreciation for equipment, and an increase in the investment tax credit (ITC). A combination of a reduction in corporate tax rates, and liberalized depreciation and investment tax credits would be another obvious alternative.

TABLE II

BUSINESS TAX CUT (By 1985)

Changes	Corporate Tax Rate	Investment Tax Credit	Depreciation
Inflation (%)	-0.2	-0.2	-0.2
Potential GNP (%)	0.2	0.6	0.7

A DRI model simulation as shown in Table II above, analyzes the expected outcomes. By 1985, the inflation rate abates somewhat and the job outlook improves. Since investments take a long lead time to plan and execute, large payoffs from business tax cuts are likely to show up later in the decade.

There are other problems associated with business tax cuts. Our political process may not have the necessary patience built into it, especially if costs have to be paid now. The "10-5-3" approach would be very costly and favors only those businesses with large fixed investments. A corporate income tax cut to benefit those businesses without a lot of brick and mortar might be more saleable. Increases in the investment tax credit would also breathe fresh air into capital spending. The problem is that a struggling firm without much income might not be able to take advantage of it. Perhaps, the ITC can be structured in such a way that a firm purchasing plant and equipment can receive direct rebates from the Federal government regardless of income.

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